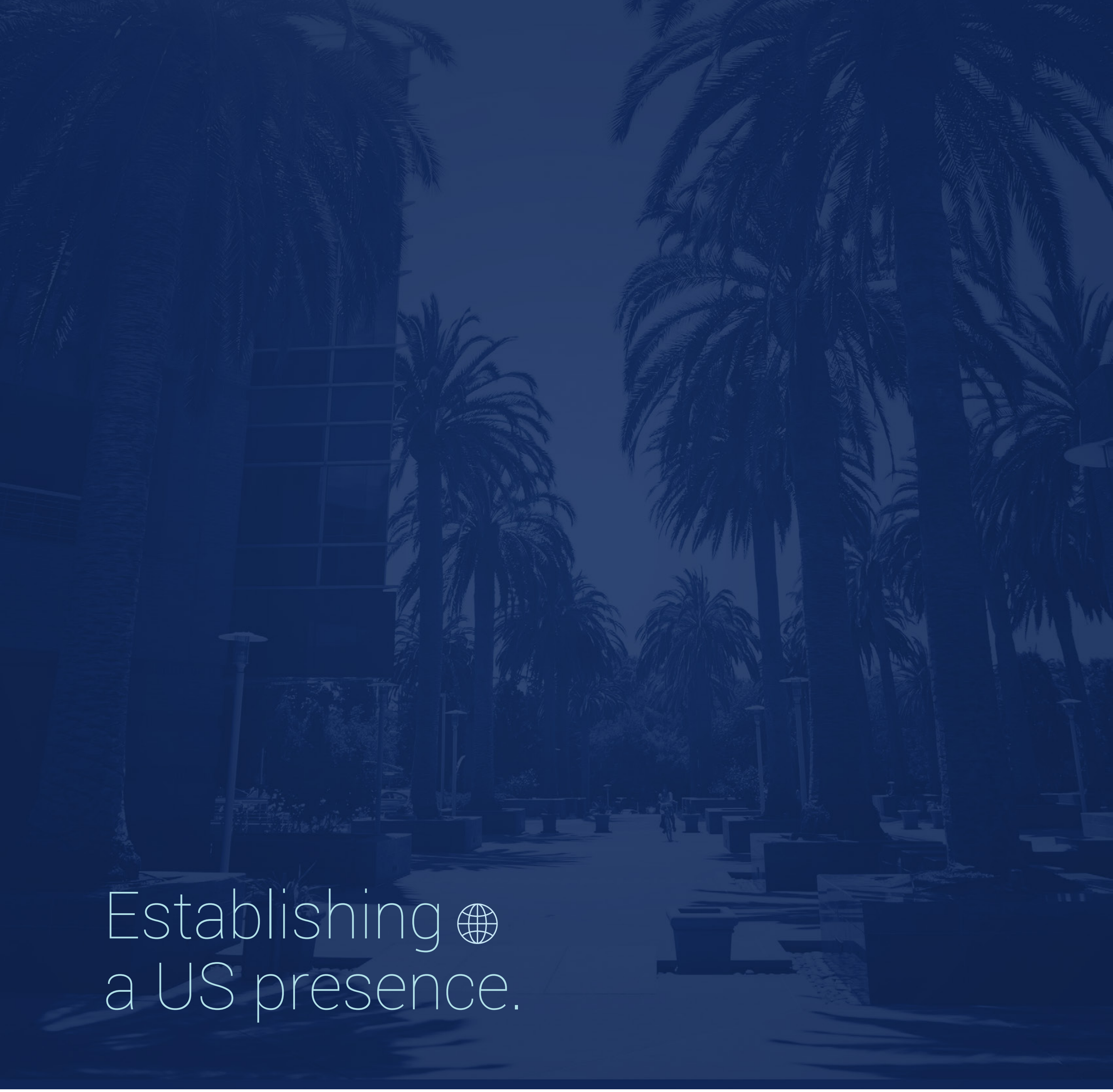

Establishing a US presence.

PACIFIC CREST
LAW PARTNERS

Establishing a US presence.

Our hope is that if you follow the steps described in this guide, you will have a clearer understanding of what needs to be done in order to enter the US market.

To use this guide, just try to answer the questions presented as best as possible and follow the instructions to the appropriate next step.
Feel free to click on (1) the check marks, (2) the "Stop" signs or (3) the "Annexes" to jump straight to those next steps.

Along the way, we will make 8 main stops, with a few side-trips. Our final destination is a clear path forward to establishing US operations.

If, for whatever reason, you get stuck and the information provided in the attached annexes do not help, do not get frustrated. Rather, drop us an email at **info@pacificcrestlaw.com** or give us a call at +1-415-398-5300 and we will do our best to get you back on the right path.

Let's begin our journey together!

Stop 1
on our Journey

Choosing the Vehicle for Establishment of Your US Presence.

Question 1: Do you know what kind of US presence you would like to establish?

If your answer is, "No, I have no idea," go to **Annex #1 – An Overview of Options for Establishing US Presence** and after reviewing that information proceed back to this Question 1. Hopefully, at that time, you can answer this question with a "Yes" in order to move forward in your journey.

If your answer is "Yes, I'm pretty sure I know what I want," proceed to **Stop 2.**

Stop 2
on our Journey

Taking Steps to Establish Your US Presence.

Question 1: Do you want to establish a Branch Office or form a US-based Entity?

If your answer is, "I want to establish a Branch Office," proceed to **Stop 3A** by clicking the checkmark above.

If your answer is "I want to establish a US-based entity," proceed to **Stop 3B** by clicking the checkmark above.

Stop 3A
on our Journey

Establishing a Branch Office.

A branch office is not a separate legal entity of your foreign entity. This means that while you want to have your foreign entity do business in the United States, you do not want to create a more formal American presence through entity formation. After reading the following 4 Steps, proceed to **Stop 7** and you will almost be done!

Step 1: Knock on the door and ask to come in.

The first step you must take in establishing a branch office of any non-US based entity is qualifying it to do business in at least one US state. All American states require foreign entities doing business within their borders to qualify as a foreign entity and be registered within that state. A foreign entity is defined as any entity that was not formed under the applicable state's laws. So, for example, both an European-formed entity and a Delaware-formed entity are foreign entities in California and each would need to qualify to do business in order to operate systematically in California.

Now, you might be wondering how do you know what state to choose? The answer often is relatively straightforward: If you know you want to establish a central branch office in a particular state, that is the state you qualify in. If you will be opening offices in multiple states (e.g., offices in San Francisco and Manhattan), you would qualify in both California and New York.

The consequences of not qualifying can outweigh the minor inconvenience and expense of the qualification process. For instance, you may lose access to the court system in the state in which you are doing business, because your company is not recognized as a business there. Further, you may face fines, penalties and back taxes for the time in which your company did business within a state without being a qualified foreign entity. Pragmatically, until you qualify to do business in at least one state, it is nearly impossible to open bank accounts or properly hire employees in the US as doing so often requires receipt of identification numbers only available to qualified companies.

For the steps required for qualifying your foreign entity to do business in a state, please see:

Annex #2 – Steps to Qualifying a Foreign Entity to do Business in a State.

Stop 3A
on our Journey

Step 2: Obtain the proverbial "FEIN,"—the key that starts the US engine.

Once you've qualified your foreign entity to do business in the state of your choosing, technically you are free to transact business in that state. However, practically speaking, in order to do any real business in that state (or anywhere in the US), you will need to obtain a Federal Employer Identification Number (a "FEIN") from the United States Internal Revenue Service (the "IRS"). An FEIN is your company's taxpayer identification number; essentially your company's identity number in the United States (the company equivalent of a Social Security Number issued to individual US taxpayers). In addition to being used to file US and state tax reports, the FEIN is required by all American banks in order to open a bank account and is also necessary to obtain employer identification numbers and accounts required by most states. As such, without an FEIN, you are pretty much stalled.

In order to learn how to obtain the FEIN, please see:

Annex #3 – How to Obtain a Federal Employer Identification Number.

Step 3: Take a drive to a bank and, along the way, pick up a few essentials for your pantry.

With your FEIN in hand and your qualification complete, you should be able to open a local US bank account, if needed. Some banks want a local address, too, so you may wish to establish a business address in the state of qualification as soon as possible (see **Annex #2 – Steps to Qualifying a Foreign Entity to do Business in a State** for more information). It is not necessary under US law to have a local US bank account so if you want to wire money from your company's home country and pay foreign currency transaction fees, knock yourself out. But, be forewarned, cashing checks made out to your company may prove difficult without a US bank account.

Depending on the type of business you are conducting through your American branch office, you may also need to obtain municipal and state business licenses. Each state has certain permit and license requirements, and each county and city within that state have their own permit and license requirements. In most situations, additional licensing requirements are minimal and any local bookkeeper or attorney can advise you in short order. With that said, each state will have an employment division requiring you to register with it in order to pay employees located in that state. In California, for instance, the California Employment Development Department issues

Stop 3A
on our Journey

employer account numbers (sometimes called state employer identification numbers or SEINs) but you need an FEIN to obtain such a number. So, be ready for that registration for sure.

Often additional permits and licenses are business-specific, and also depend on if you will actually have a physical presence (office or employees) in the state. For example, in California, many cities require that you obtain a general business license if your branch is located there. In most cases, the fee for such a license is small (e.g. $25 to $50). Some California cities, like San Francisco, refer to a business license as a business tax certificate and require city-specific tax be paid by all registrants.

Step 4: The Tax Man Cometh.

Once you've qualified to do business in a state, you will be required to abide by the tax and reporting requirements of that state. If you are qualified to do business in a state, for tax purposes you are treated just like any other business formed in that state. For instance, all California corporations and foreign corporations doing business in California are required to pay California taxes to the California Franchise Tax Board. An $800 annual minimum tax must be paid during the first quarter of each accounting period whether the corporation is active, operates at a loss, or does not do business. The actual amount of tax owed is a function of a corporation's income for the year. In most cases, until income reaches a significant level, the tax remains between $800 and $1,500 per annum. LLCs have a similar (but not identical) regime in California but the minimum tax increases from $800 based on gross receipts rather than income.

There can be even further requirements depending on your branch office's business. For instance, if you will be selling goods requiring the collection of state sales tax or if you have employees working for your branch office, you may also need to register with the appropriate state taxing authorities. For example, if you will be collecting sales tax in California, you will have to register with the California State Board of Equalization. For employer taxes in California, you must register with the California Employment Development Department, which administers collection of California-specific payroll taxes.

Always be on the lookout for state and municipal requirements. Again, a competent bookkeeper or attorney can almost always advise you on any specific requirements in very short order.

Remember, skip Stops 3B through 6B and proceed directly to Stop 7.

Stop 3B on our Journey

You Want a US-Based Entity but Which Kind?

Ready to take the entity formation plunge, are you? Well, for starters, entity formation is governed entirely by state law in the United States. Other than with respect to US federal tax issues, federal law does not apply at all.

The most popular entities for operating businesses in the United States are corporations and limited liability companies **("LLCs")***. Each of the 50 states allows for the formation of corporations and LLCs so each person looking to form a US entity has at least 100 different options (50 states multiplied by 2 entity options).

Question 1: Do you know whether you want to form a corporation or an LLC?

If your answer is, "I want to establish a corporation!" or "I want to establish an LLC!", proceed to **Stop 4.**

If your answer is, "I am not sure..." please review:

Annex #4 – Corporations vs. LLC.

After reviewing that information proceed back to this Question 1 to see if you can answer that question differently in order to move forward in your journey.

If your answer is, "I am pretty sure I need something different than a corporation or an LLC," please reach out to an experienced US business attorney for advice for your particular needs—**Stop 3B** will be your final stop on this journey at this time.

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*Given that most operating businesses in the US are either corporations or LLCs, this guide is focused solely on discussing corporation and LLCs. Your individual needs may require a different type of entity, such as a limited partnership (which are commonly used for venture capital and private equity funds).

Stop 4
on our Journey

Choosing Between the 50 States.

OK, so you know you want to form either a corporation or an LLC. That is great and a major step toward reaching your final destination. But, you still have to choose which one of the 50 states you should use to form your entity. Where to begin?

Normally, the main drivers in choosing a jurisdiction are (1) in what state is the entity likely to be principally located, (2) will stakeholders such as potential investors, partners or acquirers prefer one jurisdiction over another, and (3) what costs are likely to be incurred in forming within a particular state. These questions are explored in more detail below.

While many jurisdictions may be dismissed relatively easily, there is likely no 100% right answer on where you should form. Rather, there is simply a need to weigh certain factors to make the best-educated decision. Furthermore, if in the future it appears your choice was not optimal, reincorporating in another jurisdiction is usually not an overly complicated task. So, try your best and realize that if your choice proves for whatever reason to be undesirable in the future, there are actions that can be taken to remedy your particular situation.

Question 1: Where will principal operations of the entity likely be (at least initially)?

The answer to this question can heavily influence your decision on where to form for one simple reason: A company formed in a particular state can operate in that state without having to do much else.

For this reason, many choose to form in the state where the entity's principal business is located. For example, if you are going to open up operations in Silicon Valley, forming in California may seem desirable because once you form in California you can operate in California and there are no reporting requirements in any of the other 49 states (unless and until you open up operations in another state later).

But, while expediency and efficiency are likely gained by just forming in the state where you will operate, there are other factors you should consider before committing to forming in the state where you will operate. Therefore, please proceed to Question 2.

Stop 4
on our Journey

Question 2: Will the company's stakeholders prefer a particular jurisdiction?

You should consider whether the company's stakeholders have a preferred jurisdiction. For instance, if you have sought or plan to seek venture capital investment in your company, the investors likely will prefer that your company be formed in Delaware.

One major reason for this is that Delaware does not have in place many protections for minority shareholders. Basically, majority rules in almost all cases. This makes it easier for VCs to implement certain actions; especially if, collectively, VCs own a majority of the company's stock.

Another key reason is that with 50 states in the United States, most investors and their counsel are only familiar with two (2) states' corporate laws—(a) The state they live in and (b) Delaware. Delaware is a common denominator presenting a path of least resistance.

For additional information on why Delaware is often chosen, see:

Annex #5 – Why Delaware?

Question 3: What costs are likely to be incurred in forming within a particular state?

Cost to get things done is always a factor and is often the first consideration for most companies. States' formation fees vary greatly. For example, to form a corporation in Nevada, the state filing fees are $225 while the state filing fees in Delaware start at $89 but often increase to approximately $200 relatively quickly.

Additionally, as mentioned in **Annex #6 – The Mechanics of Corporate Formation,** if you form in a state where you will have no presence, you will have to pay a third party between $50 and $350 annually to serve as your registered agent.

Now that you have a sense of which state you wish to select for your entity formation, proceed to **Stop 5.**

Stop 5
on our Journey

Connecting Your Foreign Company to Your US-Based Entity.

Now that you've decided what type of US entity you'd like to form, and where you'd like to form it, you need to decide how you want to connect the US entity to your foreign entity.

Question 1: How will the US entity be connected to the foreign entity?

There are three main types of relationships that the US entity, on the one hand, and the foreign entity, on the other hand, can have:

1) US entity as the parent;

2) Foreign company as the parent; or

3) having the US entity and the foreign entity have identical ownership ledgers (known casually as "brother-sister companies" and more formally as "affiliates").

The type of relationship between your American entity and your foreign company usually depends on your purpose for having the American entity and the status of your foreign business.

For instance, the US entity often is set up as the parent organization if the goal is to take advantage of the US capital markets (whether via US VC investment, a US IPO, or the potential sale of the business to a large US corporation). For better or for worse, the vast majority of US venture funds are only comfortable investing in US entities. Those that are willing to invest in non-US entities usually limit their investments to (a) "piña colada" jurisdiction entities like the Cayman Islands or the BVI or (b) countries where partners of the fund are intimately familiar with business practices.

In order to set the US entity up as the parent company of a foreign entity, the US entity typically acquires all the shares of the foreign entity. However some countries have laws that may affect the number of shares acquired by the US entity, so please check with competent local counsel in the foreign entity's home country.

The US entity normally issues its shares to the current shareholders in exchange for their shares in the foreign entity. This is done via a "Share Exchange Agreement." No special permissions are required on the US side of the transaction but, some countries require government permissions on the foreign entity side of the transaction, and any such transaction may trigger certain tax liabilities in the company's home country for

Stop 5
on our Journey

the shareholders. Therefore, prior to initiating a share exchange, the foreign entity should consult with competent tax professionals and legal counsel located in the foreign entity's home country.

On the other hand, the foreign entity may be chosen as the parent if you still plan on focusing the bulk of your business and management of the company outside of the United States, have no requirement to access US capital, desire to keep intellectual property ownership outside the US, and/or only desire to establish US sales channels.

For instance, if your investors are non-US based, you may have no driving reason to be in the US other than for sales and marketing of your goods or services in the US. Moreover, if your capital strategy is based on accessing foreign government grant programs, and your business's major markets are primarily outside of the US, you may wish for the foreign entity to be the parent.

Similarly, it is appropriate for the foreign entity to be the parent if the principal operations and a significant customer base are each located in the home country and/or outside the US. This is especially true for companies selling goods or services based on intellectual property **("IP").** If IP is domesticated within the US then, generally speaking, all revenue derived from that IP is subject to US taxation. By contrast, and generally speaking, if the IP is held outside the US, then only the products and services sold within the US would be subject to US taxation.

In order to set up the foreign entity as the parent, upon formation of the US entity, shares are issued directly to the foreign entity, usually in exchange for an amount of initial capital necessary to pay projected expenses likely to be incurred in the first 90 to 180 days. The foreign entity will likely need to comply with foreign rules regulating outbound investment that, in most cases, are only bureaucratically cumbersome, like filing notices with applicable foreign governmental agencies. However, in some cases, prior approval from foreign government agencies may also be required. Again, competent tax professionals and legal counsel located in foreign should be consulted to appropriately plan for each particular circumstance.

A third option that is often invoked, at least initially, is the brother-sister option. In this set-up, the ownership ledger of the foreign entity and the US entity are identical but neither entity owns shares in the other. Why would this ever be done? Often, the long term goal is to have the US entity sit as the parent but by doing so immediately, the foreign entity could lose resources such as government grants. By keeping entities "unconnected" for the time being, operations in each jurisdiction can commence and a future reorganization can occur upon a triggering event,

Stop 5
on our Journey

like a significant VC financing. But, this approach is not without risk. VCs get nervous when entities are not formally connected, so if you follow this approach you are well-served to have a professionally drafted inter-company agreement that comports with applicable IP laws. An investor is going to want comfort in knowing that IP developed by the sister is 100% owned by the brother (assuming the investor is investing in the brother). Still, be prepared for having to explain why you chose this approach and understand that certain investors will simply not be able to get comfortable with such an approach.

Side-Trip—What about "other foreign entities," like Cayman Island or BVI corporations?

Often, future investors may not be comfortable investing in a US company or companies based in certain foreign countries. For example, Taiwanese investors are not always keen on investing in US entities because there is no tax treaty between Taiwan and the US. One popular mechanism to address this issue is establishing a "piña colada" parent that owns both the foreign entity and the US entity. Such a parent, formed in a place like the Cayman Islands, acts primarily as a holding company of the two operating companies and/or a holding company for IP, thereby minimizing tax in jurisdictions that have high tax rates on IP commercialization.

The major downside to this approach is often cost. Forming in a "piña colada" jurisdiction can often add tens of thousands of dollars on to your initial costs and compliance thereafter can quickly reach the hundreds of thousands. This is because non-"piña colada" jurisdictions have attempted to close down this approach such that, for example, no member of a board of directors can participate in a board call within the US without the entire company being subject to US tax. That means a lot of expensive international travel.

Now that you have a sense on how your foreign entity will be connected to your US-based entity, please check the appropriate circle to proceed:

If you wish to form a corporation proceed to **Stop 6A**

If you wish to form an LLC proceed to **Stop 6B**

Stop 6A
on our Journey

Creating Your Corporation.

So you have chosen a state to incorporate, potentially have a name or two that you like, and are ready to take the next steps. In order for you to truly understand the next steps, please pour yourself your favorite beverage and review:

Annex #6 –The Mechanics of Corporate Formation.

Apologies in advance for the length of **Annex #6**, but trust us. If you take the Annex paragraph by paragraph, not only will you finish a beverage (or two), but you will know all of the precise all steps required to be a “fully formed” and functioning corporation.

Congratulations! Now that you have read through the **Annex #6** in detail, you are done with the steps necessary to form your corporation. Please proceed to **Stop 7.**

Stop 6B
on our Journey

Creating Your Limited Liability Company.

So you have decided to create a LLC, decided on the appropriate state for you to form your LLC, and potentially have a name or two that you would like to use for your LLC. Now what? In order to truly understand the formation steps, please get comfortable, pour yourself your favorite beverage and review:

Annex #7 – The Mechanics of LLC Formation.

We apologize in advance for the length of **Annex #7**, but trust us. If you read through the Annex paragraph by paragraph, not only will you get to enjoy a beverage (or two), but you will also know all of the precise steps required to be a “fully formed” and functioning LLC.

Congratulations! Now that you have read through the **Annex #7** in detail, you are done with the steps necessary to form your limited liability company. Please proceed to **Stop 7.**

Stop 7
on our Journey

Preparing to Raise Capital via the US-Entity.

You now have a clear path for establishing a presence in the United States! We have one final stop and it is a big attraction known as "Fundraising!".

Question 1: Do you need to fundraise for your entity?

If your answer is "No," you've arrived!
If your answer is "Yes" or "Maybe," proceed to Question 2.

Question 2: Do you know how you want to fundraise for your entity?

If your answer is, "No, I have no idea," go to **Annex #8 – An Overview of Fundraising Options.** After reviewing that information come back to this Question 2 to see if you can answer that questions with "Yes" in order to move forward in your fundraising goals.

If your answer is "Yes, I know how I want to focus my fundraising efforts," use the information provided in **Annex #8 – An Overview of Fundraising Options** as an aid and go get them!

CONGRATULATIONS!

You have reached your final destination! Please make sure you have checked the overhead compartments prior to disembarking.

We would love to learn about your trip.
Please feel free to contact us at either:
+1-415-398-3113
or info@pacificcrestlaw.com

ANNEXES
TO ESTABLISHING A US PRESENCE

Annex # 1 – An Overview of Options for Establishing US Presence

There are two main methods to establish a US presence:

1. Create a branch office of your foreign entity in the US; or

2. Establish a US-based entity (formed under the laws of a specific US state since there is no such thing as a US entity) that is somehow connected to your foreign entity.

Deciding between the two depends on your business needs and your intended purpose for entering the US market.

Branch Offices

Establishing a US presence via a branch office is an appropriate option when you want to be present in the US but you do not need to establish another entity to do so. For instance, if all you would like to do is extend your operations to the US by conducting modest sales or marketing efforts, then a branch office might be the right choice for you. Further, a branch office might be appropriate for your company if you have no desires to fundraise via US capital, attract American investors, hire employees working in the US or otherwise transfer material business operations to the US.

A US branch office is not a separate legal entity of your foreign company. Rather, it is a way to extend an arm of your foreign company into the US to conduct business. Moreover, despite the terminology, establishing a branch office does not actually require establishing a physical presence in a US state (although this is recommended as explained in **Annex #2 –Steps to Qualifying a Foreign Entity to do Business in a State**). Rather, it simply means establishing a location, other than your main office located outside the US, where business is allowed to be conducted.

A US branch is usually not a good choice if you envision having actual and on-going operations in the US because this will require your current company to ensure it complies with all US and state-specific laws. For example, you will need your current company to register as an employer in the state in which you are operating and comply with all US federal, state and local employment laws. You also will need to file US federal and applicable state tax returns on an annual basis. Also, many US businesses will be much more comfortable contracting for services with a US-entity, rather than a foreign company that is located potentially across the globe.

Establishment of a US-based Entity.

The second, and most common and preferred, option for foreign companies is to establish a US-based entity in a US state, and then “connect” that entity to your foreign entity by common ownership, contract, or a combination of the two.

If you are set on commencing on-going business activities within the US or taking advantage of the US markets and investors, you probably should establish a US-based entity. As you can probably guess, forming a US-based entity, such as a corporation or a limited liability company, involves many more steps and, initially, can be more expensive. However, once you complete all of the steps you will have a stand-alone entity capable of focusing on US operations that will minimize the amount of on-going compliance of your foreign entity. For example, if you form a corporation within the US that is a subsidiary to your current foreign entity, the subsidiary can be the employer of all US employees and be the only entity obligated to follow US federal, state and local employment laws. Moreover, the subsidiary, a US person, would file tax returns in the US but your foreign entity would not have to file such annual returns.

In order to determine the most appropriate US-based entity for your company, please see **Annex #4 –Corporations vs. LLC.**

In order to determine how best to “connect” a US-based entity to your company, please see:

Stop 5 on our Journey — Connecting Your Foreign Company to Your US-Based Entity.

Annex # 2 – Steps to Qualifying a Foreign Entity to do Business in a State

No matter if you simply wish to open up a branch office or wish to establish a US-based entity, you are likely to have to "qualify" your operations in one or more different US states.

All American states require foreign entities doing business within their borders to qualify as a foreign entity and be registered within that state. A "foreign entity" is defined as any entity that was not formed under the applicable state's laws. For instance, an European-formed entity and a Delaware-formed entity are considered foreign entities in California and each would need to qualify to do business in order to operate systematically in California.

Each state has particular filing requirements and forms used to qualify foreign entities within their borders. Typically, you must file an "Application for Registration" or "Certificate of Authority" with the applicable state's corporation's office (often this is called the "Secretary of State).

For example, if you choose to form a Delaware corporation for your US operations and immediately establish offices with employees in San Francisco, California and Dallas, Texas, the laws of California and Texas will require that your Delaware corporation qualify to do business in both California and Texas.

Once you are qualified to do business in a state, you agree to abide by all laws, rules and regulations applicable to domestic entities. For example, if you are a Delaware corporation qualified to do business in California, generally speaking, you will be expected to comply with all California laws applicable to California corporations.

A California Example

Because California is a popular state for companies to transact business, we have provided the California requirements in this Annex as an example. Most states have very similar requirements.

In California, the first five preliminary steps to qualifying are: (1) Select a "registered agent"; (2) Choose a business address in California (not required in California but often highly recommended); (3) File the registration form applicable to the business structure of your foreign entity; (4) Attach to that form a valid certificate of good standing by an authorized public official of the foreign jurisdiction under which the foreign entity is organized; and (5) Pay the applicable filing fees. These steps are explained in detail immediately below:

Step 1:

A "registered agent" is also known as an "agent for service of process." Every entity doing business in California must have an agent for service of process on file with the State of California. A registered agent is the person designated by the entity to receive legal correspondence on its behalf. The agent may be (1) an individual residing in California or (2) a business entity authorized to do business in California, with a physical address in California. California (and many other states) provides a list of companies that can act as a registered agent; these companies charge an annual fee ranging from $50 to $350. Of course, any individual residing in California may serve as the agent for no consideration if they are willing to do so. As such, many companies appoint an officer or employee located in California to serve as the agent in order to save on costs.

Step 2:

While not required, it often is beneficial for foreign entities qualifying to do business in California to have a business address in California. Lacking a local address may make opening up a bank account in the California more difficult and may have adverse tax implications. The easiest option is to open up a physical office in California. Alternatively, if you do not plan on creating a physical presence for your company in California, you can use a third party service that provides you a local address. A common service in California is the "UPS Store". For an annual fee, services like the UPS Store provide a street address for mail in the state of qualification and will forward all mail to your company's home location.

Step 3:

What registration form you file in California depends on your company's business structure. All of the forms are easily accessible on the California Secretary of State's website (see **Annex #8 – Helpful Websites for your Journey** for a list of helpful websites). If the entity is a corporation, you must file a Statement and Designation of Foreign Corporation. The form must be completed in its entirety and signed by an officer of the corporation seeking qualification. If the entity seeking qualification in California is an LLC, you must file an Application to Register and substantially similar information is required in completing it. If your entity is an LLC, California requires you to provide a "California alternate name" for the LLC if the original name does not already contain the words "Limited Liability Company" or any abbreviated version of those three words.

Step 4:

Next, when registering in California, you must provide proof that your foreign entity is in "good standing" in the state or country of formation. Being in good standing means your entity is current with the payment of statutory dues and filing of required reports with its state or country of formation. An entity formed in one of the 50 US states can provide proof of good standing by providing a Good Standing Certificate (no older than six months old), which can be requested from the Secretary of State in the state of formation.

Unfortunately, if you are seeking to qualify a non-US based entity, not every country has the practice or even the concept of a good standing certificate. In such situations, you will have to use another document to serve as a satisfactory replacement for the good standing certificate. A professional filing service or an experienced US business attorney can advise you on what substituted documents can be submitted.

Step 5:

Finally, in order to obtain foreign qualification, you must pay California's filing fee. In California, if the entity is a foreign stock corporation, the filing fee is $100. But if the entity is a LLC, the filing fee is $70. California (along with most other states) offers expedited or rushed processing services, however as with most benefits, they come with an additional fee.

Annex # 3 – How to obtain a Federal Employer Identification Number

Before you even think about obtaining a FEIN for your company, you must answer one important question: Does a principal officer of the entity seeking an FEIN have a US social security number or American taxpayer ID?

If the answer is yes, the process is very simple. The principal officer can simply apply online on the IRS's website by answering several questions about your company.

Please see :
Annex #8 – Helpful Websites for your Journey for the relevant IRS websites.

Once everything is submitted you will be issued a FEIN immediately online. You can also obtain a FEIN over the phone, via fax, or through the mail. Alternatively, if you are working with local professionals in the US, they can file online on your behalf so long as you first complete and sign a "Form SS-4 Application for Employer Identification Number." This is a one-page form found on the IRS website, and it asks basic questions about your company. The SS-4 must be signed by a principal officer.

If the answer is no, the procedure is a bit more involved but you can still obtain an FEIN. There are two options people pursue. Option 1 is to have a principal officer apply for a US taxpayer identification number (a "TIN"). This is a bit of a cumbersome process and can take several months. Option 2, and one many entities pursue, is to retain a US-based attorney and have the company authorize him/her as the company's Third Party Designee to obtain the FEIN on the company's behalf (the attorney can prepare the necessary paperwork). With the Third Party Designee in hand, the attorney calls and faxes the IRS with certain information, including submitting an Application for Employer Identification Number (form SS-4) on behalf of the company. Once everything is received by the IRS, the attorney should receive the company's FEIN in 1 to 10 days. Unfortunately, the IRS online portal is not available in these situations.

WARNING: Do not attempt to appoint a person you know that has a US social security number as a "principal officer" solely to obtain an FEIN with the idea that once the FEIN is obtained, the person will resign or be removed from office. The US IRS has made it clear that it will seek legal redress against such filer and persons for violation of US tax law. See:

https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Use-of-Nominees-in-the-EIN-Application-Process for more information on this issue.

Annex # 4 – Corporations vs. LLC Overview

The most popular entities for operating business in the United States are corporations and limited liability companies ("LLCs"). Other entity options used in the United States are limited partnerships (which are commonly used for venture capital and private equity funds) and limited liability partnerships (commonly used for professional partnerships, like law firms and medical practices), however these are rarely used for foreign businesses looking to establish a US presence.

There is no clear answer to the question of whether an LLC or a corporation is a better business entity. Rather, the choice between the two truly depends on the type of business you plan on conducting, your current business and financial needs, and your future business and financial goals for your US entity.

Fundamentally, the main reasons to form a corporation instead of an LLC are: (1) you plan on raising money from outside investors through your US entity, (2) you plan on going public with your US entity, and/or (3) you desire to have an equity incentive plan for your employees where they gain rights to acquire equity in your US entity (e.g., stock options).

By contrast, the main reasons to form a LLC instead of a corporation for establishing a US presence are:

1) you want to have fewer formalities and legal requirements to abide by in the running of your US entity,

2) you assume there is a very good chance that a "sale" of your US presence will be accomplished via an asset sale (as opposed to a merger or stock sale), and/or

3) your foreign entity is likely to be the sole owner of the US entity and no equity incentives will be required to be granted to employees by the US entities (e.g., the parent entity will issue equity grants rather than the US entity). In addition to these reasons, there are other aspects of LLCs and corporations that can also be very important to weigh. In fact, for people looking to form just a US entity without connection to a foreign entity, there is often a different set of factors that need to be weighed.

When might I choose a corporation?

Under all US state law, a corporation is a business entity that is separate from its owners so long as certain formalities are followed. Ownership of a corporation is represented by the owners (e.g. stockholders) holding shares of the corporation's capital stock. Under US tax law, so long as any stockholder is either an entity or a non-US taxpayer or if the corporation has multiple classes/series of stock, or if there are more than 100 stockholders, the corporation is taxed as a separate person. This means a corporate tax return is due annually and tax on all profits must be paid first prior to any distributions of profits to stockholders. A significant cost of this is that a highly profitable US corporation is likely to pay tax. The major benefit of this situation is that the stockholders of a US corporation typically do not have to file US tax returns because the US corporation has filed a return and paid any taxes due.

Another main reason for forming a corporation is because your company intends to fundraise via the sale of "preferred stock" to US investors. Selling corporate stock is often just a lot easier to accomplish than selling equity in an LLC, due to the general familiarity investors have in investing in corporations. Additionally, VC and private equity funds that have pension funds as their investors are often precluded from investing in anything but corporations due to certain esoteric laws applicable to pension funds. As such, many Silicon Valley VC funds simply cannot invest in LLCs.

Moreover, US employees are often familiar with the notion of "stock option" benefits. A corporation can have a stock option plan whereby options to acquire stock in the future are granted. There is nothing overly complex about this and the rules to follow in granting these rights are well known and well versed.

Finally, LLCs are a US-centric concept. Other nations, and people in other nations, often do not understand what an LLC is. If your US enterprise will be conducting business globally, it is often just easier to conduct such business through a corporation.

When might I choose a LLC?

Like a corporation, an LLC is an entity that is separate from its owners. But, unlike a corporation, the benefit of an LLC is its "hybrid" structure. Basically, LLCs were created to combine the limited-liability benefits of a corporation with the flexibility afforded by a partnership.

Under partnership law, management of a partnership can be incredibly informal and is governed primarily by whatever contract the partners agree upon. In LLC-parlance, such an agreement is known as an "operating agreement". Moreover, partnerships are considered "pass-through" entities for tax purposes, meaning that all profits and losses of the partnership flow up to the partners, themselves, and the partnership pays no federal tax and little to no state tax. LLCs are generally taxed as partnerships, meaning that the LLC does not pay taxes on its profits, but instead, profits and losses are "passed through" to the owners, who must then pay tax on their share of LLC income. With that said, this requires all owners of an LLC to file annual US federal and state income taxes. So, often, foreign owned LLCs elect to be taxed as a corporation to avoid having to have their owners file US federal and state tax returns.

LLCs can also have equity incentive programs that are similar to stock option plans. Unfortunately, such programs are much more complex. This complexity is mainly caused by the position that once an equity interest is issued to an employee, that employee is deemed a member of the LLC and, technically speaking, is viewed as a partner under tax law. Partners, in a strange twist of fate, are not considered employees for federal tax purposes requiring the person to abide by tax reporting obligations that are foreign to most employees. If the LLC has elected to be taxed as a corporation, the issuance of equity rights in an LLC face yet a different set of complications. For these reasons alone, avoiding the issuance of equity incentives from an LLC is often recommended.

Therefore, in situations where foreign entities are looking to establish US presence, the main reason an LLC is attractive is the informality afforded to an LLC (no need for board of directors, shareholder meetings, etc.). If there is little to no chance of having to raise money through the LLC or having to issue equity incentives to employees from an LLC, an LLC may be the right choice.

Annex # 5 – Why Delaware?

Because there is no such thing as a US entity, entities are formed and exist pursuant to applicable state law within the United States. Since there are 50 states in the United States of America, there are 50 options in choosing where to form an entity in the United States.

Delaware has become a very popular and common choice for formation. In fact, more than 60% of Fortune 500 companies are incorporated in Delaware. The popularity of Delaware has led most investors to assume Delaware should be the choice for all of their portfolio companies. To add to this bias, most attorneys representing investors are typically only familiar with two (2) states' corporate laws:

a) The state they practice in; and
b) Delaware.

Therefore, Delaware is often the state that provides a path of least resistance in getting a deal done having little to nothing to do with legal issues. Instead of explaining why a different state was chosen, if you choose Delaware, investors and their counsel will check a box in their minds and move on to other issues.

But, there are actual reasons why Delaware has become and remains a popular choice. One primary reason for Delaware's popularity is due to its advanced and relatively simple corporate code. In fact, Delaware's corporate code is considered the national standard for corporation codes and many states model their corporate code after Delaware's. Importantly, because Delaware has the oldest corporate code in the country, the interpretation of these codes by courts has been robust (see below). As a result, Delaware provides companies with the stability of knowing how the code and its requirements will be interpreted. This enables directors, officers and investors to feel more secure in knowing how statutes and regulations will be interpreted, especially with respect to director and officer liability (an important topic; especially with respect to publicly traded companies) and investor rights.

Also, Delaware has a separate court (the Chancery Court) solely for the adjudication of corporate matters. This court not only means that corporate cases have a direct path to faster (and thus presumably cheaper) resolution, but also that the judges deciding corporate matters are much more familiar with corporate cases since that is all they decide. Further, because the Chancery Court does not have juries, all decisions are issued as written opinions. And, as alluded to above, these opinions create one of the largest (if not the largest) bodies of written legal precedent to rely upon.

Another reason why investors (and therefore companies) prefer Delaware is the state's corporate code does not have in place many protections for minority shareholders. Basically, majority rules in almost all cases. This makes it easier for venture capital investors to implement certain actions; especially if, collectively, the venture capital investors own a majority of the company's stock. For example, in California, shareholders holding 30% or more of the shares can force an involuntary dissolution of the corporation. This sort of minority right does not exist in Delaware.

Moreover, Delaware operates under a system of "contract interpretation," meaning that an entity's "charter" documents are usually interpreted under contract law principles. This gives investors peace of mind knowing that if something has been bargained for in a corporation's Certificate of Incorporation, for example, the courts will enforce such language as if the language was in a contract.

While Delaware is often a desirable choice on paper, care should still be given in the selection process. Many states require compliance with their laws if you operate in their state even if the company is formed in Delaware. While professionals disagree on whether these requirements are legal or not, you should understand the issues so thought you are not under a false sense of security.

Annex # 6 – Mechanics of Corporation Formation.

Establishing a corporation in the US involves multiple steps, from preliminary basic formation, to fundamental post-formation actions, and steps you must take after your corporation is formed and running to ensure you remain compliant with state laws. This Annex will go through many of the common steps necessary to truly have a "fully formed" corporation under US law.

This Annex will focus on the formation requirements in Delaware, since it is the most popular state for corporate formations in the US. While naming conventions differ from state to state, most states have virtually identical processes. Moreover, this Annex is meant to be general in nature. It is advised that you retain competent legal representation prior to attempting to form a corporation in the US.

Step 1: Choose and clear your corporation's name

First, you must choose a company name and make sure that name is available in the state where you are going to form your corporation. Your corporation's name must distinguish it from all other business entities on file in the state of incorporation, so you must first check to see if the name is available. You can check a name's availability through a registered agent (further described below), or, sometimes, by inquiring directly with the state's corporation's office (often the Secretary of State in many states). Please check the specific state's method of inquiry. An internet search to the state's website is often the fastest way to discover how to check on name availability.

Warning: Do not pay third party sites fees for searching for name availability without first exhausting efforts to contact the state, itself. These sites often take advantage of people, charging hefty fees for information that is often free to obtain.

Some states also require certain corporate designators for your corporation. For instance, while California does not require a corporate designator, Delaware requires that all corporations' names end with a corporate designator such as "Corporation," "Incorporated," "Limited" or an abbreviation of one of those words. We recommend using a corporate designator regardless of the state's requirements. Please check the state's requirements.

Please be aware that "name availability" should not be confused with "trademark rights." Whether a name is available to register is a matter of state corporate law. Whether a mark is available for use to describe a good or service is a wholly separate matter governed under state and US federal trademark law. Therefore, if the name of your company is likely to serve as a mark for your goods and services, you may also want to confer with competent trademark counsel prior to finalizing your corporate name selection.

Step 2: Complete and file your corporation's Certificate of Incorporation

With your name selected, you are ready to take the next step, filing the initial "formation document" often generically referred to as the "**Charter**." Different states have different names for the Charter. In Delaware, the Charter is called the "**Certificate of Incorporation**" and is filed with the Delaware Secretary of State. In other states, it is known as the "**Articles of Incorporation.**"

A Delaware Certificate of Incorporation must include:

1) The corporate name

2) The corporation's purpose (usually defined broadly as explained below)

3) The name and address of the corporation's agent for service of process

4) The number of shares the corporation is authorized to issue and, if necessary and applicable, the class(es) and/or series of those shares (i.e. common stock, preferred stock, Series A preferred stock, etc.) and the par value of each share

5) The name and address of the incorporator. While you may include more in the Certificate of Incorporation, these are the required elements and most newly formed corporations do not have much more than the required elements*

In Delaware, a corporation's purpose is typically stated as "to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware." This allows maximum flexibility to allow the corporation to enter into most lawful business, trades and professions.

An agent for service of process is also known as a "registered agent." Every corporation must have a registered agent in the state of formation. A registered agent is the person designated by the corporation to receive legal correspondence on behalf of the corporation. The agent may be (1) an individual residing in Delaware or (2) a company authorized to accept legal correspondence on behalf of the corporation, that is authorized to do business in Delaware and has a physical address in Delaware. These companies charge an annual fee ranging from $50 to $350. Of course, any individual residing in Delaware may serve as the agent for no consideration if they are willing to do so.

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* The Certificate of Incorporation is usually amended completely upon consummation of a stock financing. At that time, the Certificate of Incorporation can become very complex (as discussed in more detail at **Stop 7** of this guide). It is usually never advisable to try to guess in advance on what provisions to include in anticipation of a future financing. Rather, start off simply and be ready to make necessary additions after negotiation with your investors.

If the Charter is silent on classes or series of stock, Delaware corporate law treats all authorized shares as ordinary "common stock." Common stock is a type of equity security that represents ownership in a company. It is the most general form of equity security in a company granted, and is typically issued to the company's founders, management and employees. In the event of the corporation's liquidation, common stockholders receive their right to the company's assets after creditors have been repaid in full and after "preferred stock" stockholders receive any payments specified in the Charter to be remitted prior to remittance of proceeds to the holders of common stock.

If the Charter designates classes of stock, usually those classes are broken into "common stock" and "preferred stock." Preferred stock is simply a class of stock that has at least one right, preference or privilege enumerated in the Charter that is better than the rights, preferences, and privileges of the common stock. For example, if an owner of preferred stock has the right to receive $0.01 per share of preferred stock on a sale of corporation prior to an owner of common stock receiving anything, the preferred stock has a better right making his shares "preferred."

The Charter may further demarcate shares of preferred stock by "series." While each series of preferred stock have at least one right, preference or privilege enumerated in the Charter that is better than the rights, preferences, and privileges of the common stock, a series of preferred stock also has at least one right, preference or privilege enumerated in the Charter that is better or worse than the rights, preferences, and privileges of the other authorized series of preferred stock. For example, while an owner of series "a" preferred stock and an owner of series "b" preferred stock may have the right to receive $0.01 per share of preferred stock on a sale of corporation prior to an owner of common stock receiving anything, the owner of series "b" preferred stock may have the right to receive his $0.01 per share prior to the owner of the owner of series "a" preferred stock receiving his $0.01 per share, so that series "b" preferred stock has a better right than the series "a" stock though both have better rights than the common stock.

"Par value" is a vestige of the past. The corporation cannot sell its shares for below its stated par value. It can sell its shares for more than its stated par value. Therefore, it is often the case that the stated par value is very low (e.g., $0.0001 per share) and often has nothing to do with the fair market value of the shares.

The "incorporator" is simply the person or entity that is officially forming the corporation. This person does not need to be involved with the corporation, and is simply the individual or company who initiates the process of incorporation. Typically, upon formation of the corporation, the incorporator appoints the corporation's initial members of its board of directors and resigns for all purposes. It is common for your US legal counsel to act as your incorporator, though anybody can serve in this capacity.

With your Charter drafted, the next step is to file it with the appropriate state entity. Every state charges a filing fee for filing a Charter, although the fee varies among states. In Delaware, the filing fee is typically $89 if your Charter is one page, and it increases by $9 for each additional page. In Delaware, you can file the Charter by postal mail or fax, or you can have a filing service (typically, your registered agent) file it for you for a supplemental fee. Depending on the time of year, it can take anywhere from 24 hours to three (3) days for a Charter to be processed by the State of Delaware. Other states, like California, can take much longer (up to 30 days in some cases). Most states offer expedited or rushed processing services, however as with most benefits, they come with additional fees.

Step 3: Complete initial formation requirements after filing of Charter

With the Charter ready to be filed or on the way to being filed, there are a few more steps required to actually complete the formation of the corporation. Many feel like filing the Charter is enough. Under corporate law, that is not true. At a minimum, the following should also occur:

1) Initial directors on the Company's board of directors should be appointed;
2) Bylaws should be adopted;
3) Initial formal actions of the board of directors should occur; and
4) Importantly, capital stock of the corporation should be sold and issued to the initial owners.

These steps can be accomplished by executing the following documents:

1) Action of Incorporator: The "incorporator" often signs a document whereby the incorporator (the person/entity who signed the Charter) appoints the initial members of the corporation's board of directors. These directors are intended to serve until the first annual meeting of the stockholders (when the stockholders vote to elect the board members who will serve the next term). This document does not get filed with the state and the corporation simply keeps this document in the corporate minute book (as described below). In this document, the incorporator also resigns from the corporation for all purposes.

2) Corporate Bylaws: Bylaws are required pursuant to each state's corporation code and are an internal document that sets out the operating rules and corporate governance of the corporation. This document is not filed with any government entity and is simply for internal purposes. Bylaws typically have the following provisions included: setting the protocol and rules for stockholder meetings, setting the protocol and rules for board of director meetings and the rules for electing directors, setting the rules for the corporation's committees, setting the rules for the corporation's officers, setting the standards for the corporation's stock certificates, stating the corporation's duty to indemnify certain individuals and the extent of this indemnification, and establishing any other corporate governance rules the board of directors desire. For example, transfer restrictions on shares, such as rights of first refusal, can be and are often included in bylaws.

3) Initial Written Consent of the Board of Directors: After a corporation is created, its board of directors must have an initial meeting. In Delaware, a corporation can obtain the written consent of all directors instead of holding a meeting. Often, the initial directors will sign an initial written consent adopting certain introductory elements of the corporation. This initial written consent will typically appoint corporate officers (usually, at a minimum, the CEO, President, Secretary, and Treasurer (or CFO)), adopt the corporate bylaws, authorize the sale and issuances of shares of stock, set the corporation's fiscal year, adopt an official stock certificate form and corporate seal, and authorize the opening of bank accounts. Other ministerial actions can also be taken in this initial consent.

4) Stock Purchase Agreement(s) & Stock Certificates: In order for a corporation to be properly formed, it must issue shares and have sufficient initial capital. What is sufficient initial capital differs based on each corporation's situation. Generally speaking, the corporation should have access to capital that is at least equal to the corporation's projected expenses for at least the first 90 days of the corporation's existence. This amount, though, must be determined on a case-by-case basis. Moreover, for the initial owners of the corporation to have an actual ownership interest in the corporation, they must acquire shares of the corporation's stock (i.e. become a stockholder). In order to become a stockholder, each prospective owner must be issued shares of stock in exchange for some sort of consideration, typically either cash (to be invested into the corporation), an assignment of certain intellectual property rights and/or other assets, or the delivery of shares in another entity. This is often accomplished via a Stock Purchase Agreement or a Share Exchange Agreement. It is imperative that the proper documentation occur to effectuate the proper issuance of shares and ensure any conveyance of intellectual property or any share exchange is done properly. As such, it is highly recommended that you consult with a professional to determine what agreements are needed for your particular circumstance. Once the shares have been sold and issued, in most cases, the corporation should prepare paper stock certificates for each stockholder.

Step 4: Prepare your corporation for business

After completing steps 1-3, your corporation will technically be fully formed under Delaware law and the corporation's limited liability protections are likely to be in effect. However, there are a number of additional items/tasks that need to be completed to make your corporation fully functioning and ready to do business. These include:

1. Ensuring US federal and state securities law compliance occurs.
2. Obtaining the **FEIN**.
3. Opening up a bank account, if necessary.
4. Adopting applicable equity incentive plans.
5. Qualifying to do business in other states, if necessary.
6. Preparing and maintaining a minute book.
7. Being ready to file applicable tax returns.
8. Evaluating immigration law issues.
9. Obtaining any necessary additional licenses or permits.

A general overview of how to address these final tasks is as follows:

1) Security Law Compliance: Because stock is a security under American law, it must be issued in compliance with both federal and state securities laws. This means that corporations must register their stock offerings with the federal Securities and Exchange Commission (the SEC) and the state securities agency in the state of the security issuance unless there is an exemption for registration available to the corporation.

Luckily, many securities issuances qualify for exemptions from securities registration rules. For example, most states exempt "private offerings," meaning a non-advertised sale to a limited number of people (generally 35 or fewer). Federal law also exempts "private offerings" so long as certain conditions are met. Please speak to an attorney about any anticipated securities issuances to determine your registration requirements and if you qualify for any exemptions. Failing to properly register your securities can result in fines and even criminal prosecution.

2) Obtain Federal Employer Identification Number: An FEIN is your corporation's taxpayer identification number, essentially your corporation's identity number in the United States (the company equivalent of a Social Security Number issued to individual US taxpayers). In addition to being used to file US and state tax reports, the FEIN is required by all American banks in order to open a bank account and is also necessary to obtain employer identification numbers and accounts required by most states.

In order to learn how to obtain the FEIN, please see **Annex #3 – How to Obtain a Federal Employer Identification Number.**

3) Open up Corporate Bank Account: Once your company has a FEIN now you are ready to go open a corporate bank account. Because a corporation is an entity separate from its owners, if you want to put any money into the corporation, have the corporation buy anything as simple as office supplies, or have the corporation pay employees or consultants, you probably will need to open a corporate bank account for that money to go into/come from. Although there are no strict rules on the subject, it is most advisable to open the bank account in the state of the corporation's principal place of business. If you already have an American bank that you are familiar with or do business with, you can simply open up your corporation's bank account at a branch office of that bank in the state of incorporation. All you typically will need is a copy of your filed Charter, resolutions from the corporation's board of directors authorizing the opening of a bank account, the corporation's FEIN, and evidence that the corporation is qualified to do business in the state where the bank branch is located.

4) Adopt Equity Incentive Plan: If you plan on granting employees or consultants stock options as compensation or other rights to equity in the company, you will need to create and adopt an "Equity Incentive Plan" (the "Plan"). The corporation's board of directors and a majority of the corporation's stockholders must approve of and adopt the Plan.

Granting someone an option means you are granting them an option to purchase shares of the corporation (at a predetermined price) at a scheduled time in the future (pursuant to a vesting schedule which is described further below). An "option" is a security under federal and state law, so security law compliance is essential prior to granting any options.

A corporation uses a written "Equity Incentive Plan" in order to comply with US federal securities law (US SEC Rule 701, which provides a registration exemption (another type of exemption described generally above) for the issuance of securities to individuals providing services to the corporation so long as the issuance is pursuant to a written equity incentive plan; each state has an equivalent exemption).

The first step in creating and adopting a Plan is to draft the actual Plan document. While this document can be extensive, it has certain essential elements that should be included. First, it should set out how many shares of the corporation's common stock are preauthorized and "set aside" for issuance as options under the Plan. This is called the option pool. Most investors in the US desire to see a pool large enough to fulfill a corporation's needs for at least 18 months after a financing occurs. The size of the option pool can always be increased via an amendment to the Plan but the size of the pool is often used in calculating valuations of the corporation as a whole. As such, stakeholders of the corporation often want a Plan with an option pool that is acceptable to investors but is as small as possible.

A typical Plan also specifies what types of individual service providers are eligible to receive what types of grants under the plan. Under US tax rules, there are usually two types of stock options: (1) incentive stock options ("ISOs") and (2) non-statutory stock options ("NSOs"). The principal differences between the two types of options are tax benefits under US law. With respect to eligibility, ISOs are limited to the corporation's employees, meaning consultants, non-employee directors, and independent contractors are not eligible for ISO grants. NSOs can be offered to employees, non-employee directors, independent contractors and consultants.

The major benefit of an ISO is that generally speaking, the exercise of an ISO is not a taxable event under US law. As such, if a recipient receives an ISO for 10,000 shares where the exercise price is $0.01 per share in 2016 and exercises the option in full in 2018 when the shares are worth $1.01 per share, there is no tax owed. By contrast, if the option is an NSO, the exercise of the option is a taxable event so that upon exercise, the recipient would owe US tax on the difference between what he paid versus what the stock is worth (e.g., tax would be owed on $10,000 in imputed gain). Since ISO rules are US tax driven, most corporations issue NSOs to non-US employees to keep things simple.

So now that you have a Plan, and it is approved by the corporation's board of directors and stockholders, you are ready to grant options under the Plan. Before you grant an option you should decide the four main aspects of the option grant: how many shares you would like to give the individual the option to purchase, what the purchase price of those shares will be, when the individual will be able to purchase those shares (usually known as the vesting schedule and discussed below), and whether the grant will be an ISO or an NSO.

The purchase price per share for any option granted under your plan must in almost all cases be at least equal to the fair market value of the corporation's stock at the time of the option grant, as determined by the corporation's board of directors in good faith. Given that private companies have no public market for its shares, this determination is often difficult to do and many corporations hire third-party valuation firms to provide a valuation report (commonly known as a "409A Valuation Report") for which the board of directors relies. Obtaining a 409A Valuation Report is considered best practices and can cause the US IRS to refrain from imposing penalties, fees and interest charges against recipients of options should it be ultimately determined that the exercise price(s) were below fair market value at the time of grant.

A vesting schedule sets out what portion of the shares issued pursuant to an option can be purchased by the recipient at specified times. This period is called the "vesting period." Typically, option grants are set out so the shares vest proportionally over the vesting period. For instance, if an option has a four-year vesting period with equal monthly vesting, the individual can purchase 1/48th of the shares issued under the option every month over the four-year period. This means that once the four years are over, all of the shares issued under the option will be vested and exercisable and available for the individual to purchase. Also, vesting is normally made contingent on the individual being an active service provider of the corporation on each vesting date. Vesting gives an individual the right to acquire the optioned shares over time, which gives the recipient an incentive to perform well and an incentive to remain with the company. Although a vesting schedule is typically time-based, it can also be based on milestones.

When the corporation is ready to grant either an ISO or an NSO, it: (1) obtains approval from the plan administrator (typically the corporation's board) of the grant(s); and (2) enters into a stock option agreement with the individual. The stock option agreement typically sets out the parameters of the grant: how many shares will be granted under the option, the purchase price of those shares, the vesting schedule, and whether it is an ISO or an NSO. This agreement also incorporates by reference all terms contained in the plan.

5) Qualify to do Business in Other States: If you plan on conducting business in another American state, you will need to qualify to do business in that state. Unfortunately, there is no set definition of what it means to "conduct business" in another state. If you have an office in another state, have employees in another state, or routinely accept sales in another state, you are most likely conducting business in that state and will need to register with that state by qualifying to do business there. States require all foreign (foreign meaning out of state or out of country) corporations doing business within their borders to qualify to do business, and the consequences of not qualifying can outweigh the minor inconvenience and expense of the qualification process. For instance, you may lose access to the court system in the state in which you are doing business because your company is not recognized as a business there. This loss of access includes both suing others and defending yourself in any lawsuit brought against you. Further, you may face fines, penalties and back taxes for the time in which your company did business within a state without being qualified.

For the steps required to qualify to do business in another state, please see **Annex #2 – Steps to Qualifying a Foreign Entity to do Business in a State.**

Also, once you've qualified to do business in a state, you will be required to abide by the tax and reporting requirements of that state. If you are qualified to do business in a state, for tax purposes you are treated just like any other business formed in that state.

6) Record Keeping: A corporation should maintain a minute book containing all of the corporation's important papers such as the Charter (and all amendments to the

Charter), minutes of board of director and stockholder meetings (inclusive of all written consents), bylaws, copies of all permits and licenses, and a stock ledger.

7) Applicable Tax Returns: A corporation is subject to US federal tax and state tax in its state of formation and in each state in which it is qualified to do business. All Delaware corporations, for example, must, at a minimum, file an annual report and pay a franchise tax along with it. The taxes and annual reports in Delaware are due March 1st of each year. For Delaware corporations having modest operations, the annual taxes and fees paid to Delaware is usually between $500 and $1,000. Additional, applicable US federal and state income tax returns are due annually. If a corporation is on a calendar year fiscal year, these returns are typically due in April of each year.

8) Evaluate Immigration Law Issues: If there are no US persons involved in the operations of the business and the business desires to have representatives in the US, an appropriate work visa must first be obtained. There are three general categories of work visas: temporary (nonimmigrant) workers, permanent (immigrant) workers, and temporary visitors for business. There are 21 temporary work visas available in the United States, each with various applications and requirements. The standards for obtaining a permanent work visa (or green card) are much stricter, and require that the subject employee meets certain very specific requirements set out in the five employment-based immigrant (permanent) visa preferences. If you intend to obtain visas for your employees, we strongly recommend that you engage competent US immigration counsel.

9) Licenses and Registrations: Depending on the type of business your corporation will conduct, you may also need to obtain municipal and state business licenses. Each state has certain permit and license requirements, and each county and city within that state have their own permit and license requirements. In most situations, additional licensing requirements are minimal and any local bookkeeper or attorney can advise you in short order. With that said, each state will have an employment division requiring you to register with it in order to pay employees located in that state. In Delaware, for instance, all businesses with employees must register with the Delaware Division of Unemployment Insurance and the Delaware Division of Corporations. So, be ready for that registration for sure.

Often additional permits and licenses are business-specific, and also depend on if you will actually have a physical presence (office or employees) in the state. For example, Delaware requires any person or entity conducting a trade or business in Delaware to obtain a Delaware business license from the Delaware Division of Revenue. This includes entities located in Delaware who conduct their business outside of the state. This license must be obtained at the time business commences in Delaware.

Annex # 7 – The Mechanics of LLC Formation

Forming a LLC in the US involves multiple steps, from preliminary basic formation, to fundamental post-formation actions, and steps you must take to prepare your LLC for business. This Annex will go through each of these steps and explain them on the way, to ensure that you have a solid understanding of what it takes to have a "fully formed" LLC in (at least) one US state. This Annex will focus on Delaware's formation requirements, since Delaware is one of the most popular states for LLCs in the US.

Step 1: Choose and clear your LLC's name

First, you must choose a company name and you must make sure that your chosen name is available in the state where you are going to form your LLC. Your company's name must distinguish it from all other business entities on file in the state of formation, so you must first check to make sure no one else is using your chosen name. You can check a name's availability through a registered agent (further described below), or, sometimes, by inquiring directly with the state's corporation's office (often the Secretary of State in many states). Please check the specific state's method of inquiry. An internet search to the state's website is often the fastest way to discover how to check on name availability.

Warning: Do not pay third party sites fees for searching for name availability without first exhausting efforts to contact the state, itself. These sites often take advantage of people, charging hefty fees for information that is often free to obtain.

Some states also require the use of certain company designators for your LLC. Both California and Delaware require that all LLC names end with or include a company designator such as "Limited Liability Company" or an abbreviated version of any or all of those three words (including the abbreviation "L.L.C." or "LLC"). We recommend using a company designator regardless of the state's requirements, since they help better identify your company. Please check your state for formation's naming requirements.

Please be aware that "name availability" should not be confused with "trademark rights." Whether a name is available to register is a matter of state corporate law. Whether a mark is available for use to describe a good or service is a wholly separate matter governed under state and US federal trademark law. Therefore, if the name of your company is likely to serve as a mark for your goods and services, you may also want to confer with competent trademark counsel prior to finalizing your corporate name selection.

Step 2: Complete and file your LLC's Certificate of Formation

With your name ready to go, you are ready to take the next step, filing the initial formation document. Different states have different names for the LLC formation document. In California, this document is called the **"Articles of Organization"** and is filed with the California Secretary of State. In Delaware, this document is called the **"Certification of Formation"** and is filed with the Delaware Secretary of State.

Each state usually only requires a few items in your Certificate of Formation, and because of this most newly formed entities have relatively simple Certificates of Formation. In fact, many states make available a form Certificate of Formation on its website. In Delaware, the Certificate of Formation must include

1) The LLC's name
2) The name and address of the LLC's registered agent.

In addition to these two required elements we also suggest including, at a minimum:

3) the LLC's purpose (usually defined broadly as explained below)
4) how the LLC will be managed (e.g. "The company shall be managed in accordance with the terms of its limited liability company agreement, as it may be amended from time to time")
5) a statement disclaiming personal liability for the members of the LLC
6) a reservation of the right to amend or repeal any provision of the Certificate.

As mentioned prior, most newly formed companies do not have much more than the required elements. The Certificate of Formation can be signed by any "authorized person," meaning any person authorized to sign on behalf of the LLC, such as a member or the LLC's attorney.

A "registered agent" is also known as an agent for service of process. Every LLC must have an agent for service of process in the state of formation. A registered agent is the person designated by the LLC to receive legal correspondence on behalf of the LLC. The agent may be (1) an individual residing in the state of formation or (2) a company authorized to accept legal correspondence on behalf of the LLC, that is authorized to do business in Delaware and has a physical address in Delaware. The states often provide a list of companies that can act as a registered agent; these companies charge an annual fee ranging from $50 to $350. Of course, any individual residing in the state of formation may serve as the agent for no consideration if they are willing to do so. As such, many LLC appoint an officer or employee located in the state of formation to serve as the agent in order to save on costs.

In Delaware, a LLC's purpose is typically stated as "to engage in any lawful act or activity for which a limited liability company may be organized under the Delaware Limited Liability Company Act."

We suggest including a statement disclaiming personal liability for the members of the LLC to ensure that the members receive the benefits of a LLC, in the chance that the company is found to not technically be a LLC. The standard language we suggest is: "No member of this company shall be obligated personally for any debt, obligation, or liability of the company solely by reason of being a member of this company. The failure to observe any formalities relating to the business or affairs of this company shall not be grounds for imposing personal liability on any member for the debts, obligations, or liabilities of this company."

With your name and registered agent ready to go, and your Certificate of Formation completed, the next step is to file it with the appropriate state entity. Every state charges a filing fee for filing a Certificate of Formation (or the equivalent document), although the fee varies among states. In Delaware, the filing fee is typically $90, and you may file it by postal mail, fax, or have your registered agent file it if they are a company that provides this service (they will likely charge a service fee for doing so). In California, the filing fee is $70, and the Articles of Organization (the California version of a Certificate of Formation) may be filed by postal mail or hand delivered. Depending on the time of year, it can take anywhere from 24 hours to two weeks for a Certificate of Formation to be processed by the state. Most states do offer expedited or rushed processing services, however as with most benefits, they come with an additional fee.

Step 3: Complete initial formation requirements after filing of Certificate of Formation

With the Certificate of Formation ready to be filed or on the way to being filed, there are a few more steps required to actually complete the formation. Lucky for you, forming a LLC is much simpler than forming a corporation. At a minimum, in Delaware the following should occur after filing the Certificate of Formation:

1) Determine the member management structure of the LLC;
2) Draft an operating agreement.

(1) There are two kinds of LLCs: a **single member LLC** or a **multiple member LLC.** These names are relatively self-explanatory; a single member LLC has one member/owner, while a multiple member LLC has multiple members/owners. There is no rule regarding the amount of owners/members that an LLC is required to have, as long as there is one.

(2) **Operating Agreement:** An Operating Agreement is a necessary part of running a LLC, even a single-member LLC. It is an internal document that sets out the operating rules, LLC governance and member relationships of the LLC. It is a virtual equivalent to a partnership agreement used by partners. The Operating Agreement is not filed with any government entity. The Operating Agreement establishes the members' percentage interests in the business, the members' rights and responsibilities and the members' voting power. It also sets out the rules that govern the LLC, such as how profits will be split, how major business decisions will be made, the procedures for handling the departure and addition of members, the rules for holding meetings and taking votes, and the LLC's dissolution procedures. It helps you ensure clarity among the LLC's members and enables your LLC to be governed by your own (within the legally allowed) operating rules, instead of the default rules in your state's LLC laws.

Some states, such as California, require another formation step. California requires that every California and foreign LLC registered in California file a Statement of Information within 90 days after registering with the state. Thereafter, a Statement of Information must be filed every two years during the applicable filing period. Delaware does not have a similar requirement. You should check each state's filing requirements once you have registered your LLC.

Step 4: Prepare your LLC for business

After completing steps 1-3, your LLC will technically be fully formed under Delaware law. However, there are a number of additional items/tasks that need to be completed to make your LLC fully functioning and ready to do business. They include:

1. Obtaining a federal employer identification number (an "**FEIN**").
2. Opening up a bank account if necessary.
3. Qualifying to do business in other states if necessary.
4. Preparing and maintaining a corporate record book.
5. Being ready to file applicable tax returns.
6. Evaluating immigration law issues.
7. Obtaining any necessary licenses.

These final steps are usually accomplished as follows:

1) Obtain Federal Employer Identification Number: A FEIN is your LLC's taxpayer identification number, essentially your LLC's identity number in the United States (the company equivalent of a Social Security Number issued to individual US taxpayers). In addition to being used to file US and state tax reports, the FEIN is required by all American banks in order to open a bank account and is also necessary obtain employer identification numbers and accounts required by most states.

In order to learn how to obtain the FEIN, please see **Annex #3 – How to Obtain a Federal Employer Identification Number.**

2) Open up Company Bank Account: Once your company has a FEIN you are ready to open a company bank account. Although there are no strict rules on the subject, it is most advisable to open the bank account in the state of the company's principal place of business. If you already have an American bank that you are familiar with or do business with, you can simply open up your company's bank account at a branch office of that bank in the state of your company's principal place of business. All you will need is your company's FEIN.

3) Qualify to do Business in Other States: If you plan on conducting business in another American state, you will need to qualify to do business in that state. Unfortunately, there is no set definition of what it means to "conduct business" in another state. If you have an office in another state, have employees in another state, or routinely accept sales in another state, you are most likely conducting business in that state and will need to register with that state by qualifying to do business there. States require all foreign (foreign meaning out of state or out of country) corporations doing business within their borders to qualify to do business, and the consequences of not qualifying can outweigh the minor inconvenience and expense of the qualification process. For instance, you may lose access to the court system in the state in which you are doing business because your company is not recognized as a business there. This loss of access includes both suing others and defending yourself in any lawsuit brought against you. Further, you may face fines, penalties and back taxes for the time in which your company did business within a state without being qualified.

For the steps required to qualify to do business in another state, please see **Annex #2 – Steps to Qualifying a Foreign Entity to do Business in a State.**

Also, once you've qualified to do business in a state, you will be required to abide by the tax and reporting requirements of that state. If you are qualified to do business in a state, for tax purposes you are treated just like any other business formed in that state.

4) Record Keeping: A company should maintain a record book (or minute book) containing all of the company's important papers such as its Certificate of Formation, Operating Agreement, any government filings, and similar documents.

5) Applicable Tax Returns: Typically, an LLC is not treated as separate tax entity like a corporation, unless owners of an LLC have affirmatively elected to be taxed like a corporation. Instead, an LLC is deemed a “pass-through entity.” As a result, all of the profits and losses of the LLC “pass through” the LLC to the owners, who then report that information on their American personal tax returns. LLC owners (or members) are responsible for setting aside enough money to pay taxes on their share of the LLC’s profits and must make quarterly payments to the IRS. As a result, the LLC itself does not pay federal income tax. However, some states still impose annual taxes on LLCs, so you must check the rules in your state of formation.

For instance, in Delaware all LLCs and foreign LLCs must pay an annual $300 Alternative Entity Tax by June 1 of each year. The tax is paid to the Delaware Division of Corporations Franchise Tax Section. Similarly, in California, LLCs and foreign LLCs doing business in California must pay California taxes to the California Franchise Tax Board if they are organized/registered/conduct business in California, and they have not elected to be taxed as a corporation.

Further, depending on the business and structure of the LLC, you might have to pay additional taxes. For instance, in Delaware, if you will be selling goods and paying Delaware’s gross receipts tax or if you have employees, you must register with the Delaware Division of Revenue. Moreover, in California for example, if you will have employees, you will have to register with the California Employment Development Department in order to pay employer taxes.

If you will regularly need to keep a substantial amount of profits in your LLC, you might want to consider electing corporate taxation status for tax purposes. You can do so by filing documentation with the IRS. The corporate income tax rates for the first $75,000 of corporate taxable income are lower than the individual income tax rates that apply to most LLC owners, which can save you and your co-owners money in overall taxes. In addition, electing corporate taxation can allow a LLC to offer owners and employees various tax-advantaged fringe benefits, stock options, and stock ownership plans. It can also be an option if there are no American members/owners of the LLC.

6) Evaluate Immigration Law Issues: If there are no US persons involved in the operations of the business and the business desires to have representatives in the US, an appropriate work visa must first be obtained. There are three general categories of work visas: temporary (nonimmigrant) workers, permanent (immigrant) workers, and temporary visitors for business. There are 21 temporary work visas available in the United States, each with various applications and requirements. The standards for obtaining a permanent work visa (or green card) are much stricter, and require that the subject employee meets certain very specific requirements out in the five employment-based immigrant (permanent) visa preferences. If you intend to obtain visas for your employees, we strongly recommend that you engage separate immigration counsel.

7) Licenses and Registrations: Depending on the type of business of your LLC, you may also need to obtain municipal and state business licenses. Each state has certain permit and license requirements, and each county and city within that state have their own permit and license requirements. In most situations, additional licensing requirements are minimal and any local bookkeeper or attorney can advise you in short order. With that said, each state will have an employment division requiring you to register with it in order to pay employees located in that state. In Delaware, for instance, all businesses with employees must register with the Delaware Division of Unemployment Insurance and the Delaware Division of Corporations. So, be ready for that registration for sure.

Often additional permits and licenses are business-specific, and also depend on if you will actually have a physical presence (office or employees) in the state. For example, Delaware requires any person or entity conducting a trade or business in Delaware is required to obtain a Delaware business license from the Delaware Division of Revenue. This includes entities located in Delaware who conduct their business outside of the state. This license must be obtained at the time business commences in Delaware.

Annex # 8 – An Overview of Fundraising Options

In the US, fundraising for privately held entities typically occurs in one of the following ways:

1. Selling equity to investors via a private placement;
2. Issuing convertible debt or "hybrid" instruments;
3. Attempting to raise money via the public capital markets through either an initial public offering or through a reverse merger into a publicly traded shell;
4. Borrowing funds on commercial terms (e.g., bank debt or mezzanine financing); or
5. A combination of 1, 2 or 3.

1) Selling Equity Via a Private Placement:

Fundraising through selling equity directly to investors via a private placement is one of the most common forms of fundraising within the United States. Depending on your needs, the stage of your company's development, and the industry your company operates, private placements are most commonly of interest either to "angel" investors, venture capital firms, or private equity firms.

Angels are individuals or groups of individuals that are independently wealthy. Normally, angels invest in very early stage companies where the initial capital needs are between $100,000 and $2,000,000. More often then not, angels invest in spaces that they know very well. Successful consumer product entrepreneurs are likely to invest in a young fitness bag company while a former CEO of a software company is more likely to invest in SaaS business or a mobile app company.

Venture capital firms focus on technology and biotech related start-ups in a myriad of industries. The firms usually look to acquire a significant minority interest in a technology company and often look for deals requiring anywhere between $2,000,000 to $15,000,000 in initial funding. Large VC funds have significant reserves to participate in future funding rounds. The vast majority of these firms are purely financial investors where the partners have industry expertise. In the past 10 years, there has also been a growing number of corporate VC departments where large corporations have set up VC divisions to invest in start-ups that may support the corporation's product lines in the future; basically an outsourced "research and development" department. These groups are less concerned with valuation arguments and more concerned on having a potential path to acquire or gain exclusive access to the underlying technology the start-up is developing.

Private equity firms, by contrast, look to acquire a majority interest in its portfolio companies. Often, these types of firms look to acquire small companies that have significant revenues but lack the ability to scale due to their size. In an ideal world, a private equity firm will take over a corporation and acquire other similar corporations where the combined entity has the ability to scale collectively. At that point, the private equity firm looks to liquidate its combined investments.

Once you identify an investor or group of investors interested in your company, the steps to consummating a deal, in their simplest form is:

a) To mutually agree upon a valuation of the corporation,
b) Negotiate any special rights the investors may be entitled to, and
c) Consummate the transaction by selling shares having those special rights enumerated in an amended Charter and various contracts at a per share price based on the agreed upon valuation.

While valuation may seem intuitive, it often is not. Dollar values offered by investor groups may be highly misleading because, in the US, valuation is usually based on a "fully-diluted basis". This completely non-intuitive term means you take the enterprise valuation offered by an investor and divide into it the sum of

a) The number of shares that have been issued and are currently outstanding,
b) The number of shares that may be issued in the future pursuant to options, warrants or other rights that are currently outstanding, and, most importantly
c) The number of shares that will be available for future grants pursuant to an Equity Incentive Plan (e.g., the size of the available option pool). The resultant number is the per share price to be paid by the investors.

Because the size of the available option pool required by different investors can vary dramatically, this last number used to calculate per share purchase price can really work against the current owners of the corporation.

For example, assume an investor offers a $10,000,000 valuation and is willing to invest $5,000,000 for a 33.33% ownership interest but requires a 33.33% available option pool post-financing. Also assume the corporation has 5,000,000 issued and outstanding shares and zero outstanding options and warrants, the corporation will need an option pool of 5,000,000 shares. This results in a per share price of $1.00 ($10,000,000 divided by 10,000,000 total "fully-diluted" shares). In the end, the investors receive 5,000,000 shares, the current owners hold 5,000,000 shares, and the option pool has 5,000,000 shares available for future grant. This actually means that on an actual issued basis, the investors own 50% of the corporation and the current owners own 50%.

Contrast the above by assuming identical facts but lower the valuation to $9,000,000 and instead of a 33.33% available option pool, the investor requires only a 10.00% available option pool. The end result is that for $5,000,000, the investors would expect a fully-diluted ownership equal to 35.7% ($5M/$14M), which sounds bad. But, with the required option pool only being 10.00%, the pool only would need 921,053 shares resulting in a per share price equal to $1.52 per share (instead of $1.00 per share). This results in issuing to the investor only 3,289,474 shares. This results in the investors owning 40% of the corporation and the current owners owning 60% of the corporation on an actual issued basis.

As you can see from the above example, while a $10,000,000 valuation may seem "better" than a $9,000,000 valuation, that is not necessarily the case.

Once valuation is agreed upon, investors often demand rights, preferences and privileges making the shares they will be issued (e.g., "preferred stock") more attractive then the shares owned by the current owners (e.g., "common stock"). Common rights, preferences and privileges investors seek include:

1. A dividend preference where before any dividends can be issued to the common stockholders, the preferred stockholders must first receive a dividend usually equal to 6% to 10% of the per share price for the applicable preferred shares;
2. A liquidation preference where before any money is distributed to common stockholders upon a sale of the business, a certain amount must be returned to the preferred stockholders. This is often an amount equal to the original purchase price for the preferred shares;
3. A participation preference where the preferred stock participates in the distribution of remaining assets after (and in addition to) their receipt of payment of the liquidation preference. Usually participation is capped at a certain amount (2 to 4 times original purchase price). In good funding environments, there is no participation preference;
4. The ability to convert preferred shares into common stock in order to participate fully in the proceeds of a sale;
5. The right to appoint one or more members of the board of directors; and
6. The right to approve certain fundamental transactions like a sale of the business or the sale of a new series or class of stock.

Additionally, investors often negotiate for other contractual rights such as (a) inspection and information rights; (b) participation rights (a right to participate in future rounds of financing); (c) co-sale rights and rights of first refusal rules where the investors can either purchase shares a founder wishes to sell to a third-party or choose to participate in such a sale to the third-party; and (d) registration rights that provide a pathway to selling shares on public exchanges in the future. Additionally, it is customary for the corporation to pay legal fees incurred by the investors to a certain extent. Depending on the size and complexity of the round, this amount can range between $50,0000 to $50,000.

In the US, it is customary to name your type of preferred stock in alpha-numeric order. The first round is often labeled a "series seed preferred stock". Subsequent rounds are typically labeled "series a preferred stock," "series b preferred stock," "series c preferred stock," etc.

While the above is meant to provide a solid overview of what you should expect, no one private placement is the same as another. There are many other terms and conditions that may be demanded. An experienced US attorney can explain these terms to you in short order.

2) Convertible Debt and Other Hybrid Financings:

Often, companies are not yet in a position to raise a significant round of financing via the sale of stock but still have the opportunity and desire to raise funds sufficient to help spark development and operations. Wishing to avoid having premature arguments about valuation and the need to address all the other terms an equity round would require, the company often looks for alternative ways to raise funds. In the US, the most popular way to "bridge" this gap in this situation is to sell and issue "convertible promissory notes" to initial investors. In recent years, hybrid-financing instruments, like the Y Combinator SAFE instrument, have also gained popularity. Each is discussed in turn below:

"Convertible promissory notes" are debt. Make no mistake about it. At its core, the company is borrowing money from one or more investor pursuant to the terms of a promissory note, which requires repayment by a certain date and the accrual of interest. What makes convertible promissory notes different than a simple promissory note is that the terms included in a convertible promissory note also includes a direct pathway where the note will be repaid in the future with stock rather than with money (making the promissory note "convertible"). It is always important to remember that while a convertible promissory note might convert into equity (and both you and the investor have every intention of the convertible promissory note to convert into equity), it is debt owed by the company and you should always be prepared for the possibility of repaying the principal and interests amounts should the conversion requirements not occur. If the elements that lead to conversion do not occur, amounts borrowed under a convertible promissory note will be due and the investor will have legal rights as a lender.

From the investor's perspective, several factors are incredibly important. The investor is usually interested in the upside potential your company represents and likely is not really interested in receiving only interest payment for what is likely to be relatively risky investment. So, the investor wants to make sure if good things happen (like a quick acquisition), the investor truly shares in the success. Also, while the investor may be willing to defer arguments about valuation and terms, the investor does not want to be discriminated against in a future equity round and really does not want the investor's money to prejudice him by helping the company spike its valuation to a point that the shares received in the conversion are minimal at best.

To address these concerns, the company usually provides most, if not all, of the following to the investor within the terms of the convertible promissory note:

1) Conversion Terms.

Typically, there is a requirement that the note will automatically convert into the exact same shares of the company's capital sold and issued in a "Qualified Financing" based on pro-investor conversion formula.

A "Qualified Financing" is defined as the sale of shares that raises a significant amount of money. The amount is always specified in the convertible promissory note but varies from company to company and industry to industry. The reason for this "floor" amount is that many investors want to make sure that they only give up their debt instrument (and the additional protection it may afford the holder as compared to a holder of equity) at a time in which the company has demonstrated that it is healthier and sustainable and it prevents a company to "force" a conversion through consummating a modest round.

The conversion formula is used to calculate how many shares a note-holder will receive in the conversion. This formula is usually defined in a "greater than" way. The investor usually receives the greater number of shares based on two independent calculations:

The first calculation is simply dividing all amounts owed under the convertible promissory note at the time of conversion by the result of multiplying the per share price paid by the new investors multiplied by a "discount rate". A typical discount is 15-25%, resulting in a discount rate of between 85% and 75% (though this number can vary from deal to deal). A discount rate is provided to the investor to reward the investor in recognition of the added risk taken by the investor by investing earlier than the new investors.

The second calculation is based on what is known as a "valuation cap". The "valuation cap" is an assumed enterprise value stated in the promissory note (e.g., the "Valuation Cap" shall be $5,000,000) used to calculate an assumed per share price in the next round. For example, if the new investors agree upon a $10,000,000 valuation with the company resulting in a per share price of $1.00, if the Valuation Cap in the promissory note is $5,000,000, the assumed per share price would be $0.50. You then take this assumed per share price and divide this amount into the amount owed under the convertible promissory note. This results in the noteholder receiving twice as many shares in the financing then if the investor had no valuation cap (and no discount rate).

2) Special Repayment Terms Upon Acquisition.

To address what happens if the company never does an equity round, but, instead, is acquired, convertible promissory notes often include language to ensure an investor shares in the "upside" in any such acquisition. This is usually done in one or two ways. The convertible promissory note often includes language that says if the company is acquired prior to conversion of the note, the amount owed under the note increases substantially (100% to 400%). Alternatively, convertible promissory notes can also allow the investor to choose to convert the note into equity at the "valuation cap" immediately prior to the acquisition. Caution should be implemented prior to agreeing to allow pre-acquisition conversion due to a number of factors that can add unforeseen complexities.

Given that convertible promissory notes are debt requiring interest accrual under IRS tax law and requiring a repayment date of some sort, in recent years, there has been a push to create new instruments that avoid these requirements. A few years ago, the Y Combinator organization published documents they titled as a "SAFE" (simple agreement for future equity). A SAFE is structured to neither be debt nor be equity. Rather, it is an investment contract that basically has all of the components of a typical convertible promissory note but because it is not supposed to be debt, it does not have an interest rate and does not have a repayment date. Advocates of SAFEs say that a company that issues SAFEs avoid burdening its balance sheet with debt and have no pressure to consummate a financing by a particular date because there is no repayment date. Instead, if, and only if, the company consummates an equity financing will the SAFE trigger conversion into shares. Critics of SAFEs view the position that SAFEs will not burden a balance sheet with a degree of speculation. The sale of a SAFE is an investment contract and money is owed back to the holder of the SAFE on a sale of the company or even a bankruptcy of the company so the company needs to account for this in one way or another. Moreover, if you are representing an investor, a SAFE puts you in a bit of "no man's land" should the company simply not work out. It may be very difficult to "write-down" your loss on a company if you hold a SAFE since the company may just whither away and never formally dissolve or file for bankruptcy protection. Moreover, while an investor is not usually too interested in interest rate payments, the accrual of interest acts as an added discount upon conversion—the more money owed at the time of conversion, the more shares the investor receives. As such, a smart investor will require a larger discount rate and a lower valuation cap before accepting a SAFE over a convertible promissory note.

3) Raising Money Via the Public Market:

Another alternative for trying to raise capital is to look to list shares on a public exchange (e.g., NYSE or NASDAQ) or otherwise make your shares available for public trading. Being publicly traded is a major decision that should not be taken lightly. In recent years, exciting start-ups like Dropbox and Uber have done all they could to avoid "going public" given the high costs and overhead involved in being a publicly traded company and the requirements to basically disclose your entire operations for the world to see. Why assume the responsibility of being subject to public company compliance if you can raise sufficient funds through a private offering?

Still, if your company has a big enough enterprise value, which most would say should be at least $200,000,000, a public offering of some sort may be attractive to you. A proper IPO includes having underwriters willing to assist your company and market makers willing to participate in the trading of your shares after the IPO is effective. Without a market for trading your stock, analysts are unlikely to follow your company, trading will dry up, and you could be faced as being a "zombie" company where stockholders have really no liquidity despite being a publicly traded stock.

The above risks are a major drawback to what became a popular "product" about 15 years ago – the reverse merger into a publicly traded shell. Under this strategy, an "investment banker" either procures a bankrupted public company or creates a corporation and takes steps to list it as a public company. Since the entity has no assets, the listing procedures are streamlined, though still extensive. Basically, you have an empty corporation that has been "approved" to trade its stock on the public exchange. Next, the investment banker targets young operating corporations and convinces them that through a little legal maneuvering, they can be a publicly traded company overnight. This is mechanically accomplished by having the public shell set up a subsidiary and your corporation is merged into the subsidiary in exchange for shares in the public shell. The result is that your operating company is now owned by a public shell holding company.

The promise of a reverse merger is that investors will be highly attractive to investing in a corporation that is liquid due to it being public. But, in most cases, these investors never amount to much and once you are publicly traded, you are left with the responsibilities of complying with all applicable securities laws related to public companies. In the most successful cases, you raise a modest amount of money via the merger and then close a “private placement into a public entity” round of financing (known as a “PIPE”). A PIPE is basically an equivalent to a typical private placement. The shares sold in a PIPE cannot be traded publicly initially but the concept is that since the company is already publicly listed, there is a clear path to registering these shares.

The bottom-line is that even the best structured reverse merger transaction has very high transaction costs (typically $50,000 to $200,000 in professional service fees plus “investment banking fees” of 6% or more) and straddles the corporation with burdensome compliance requirements going forward. Moreover, creating a liquid market for your shares can prove futile making future fundraising incredibly difficult.

4) Borrowing Funds on Commercial Terms:

For corporations that have inventory, accounts receivable, or other hard assets, fundraising can be supplemented through commercial debt. While traditional bank financing may be available, for companies that may not meet the strict lending requirements of banks, there are “venture lenders” and other mezzanine financing firms that may provide lending facilities.

A “venture lender” is typically a financial institution that is willing to lend money to corporations that have at least one major VC fund equity investor. The concept is that most VC funds will not just let a new investment fail without helping to raise at least one more round of financing. Venture lenders, knowing this, are often willing to lend amounts that are between 10% and 25% of the amount the corporation raised in its most recent round. Terms are more aggressive than bank terms, usually requiring significant interest rates (up to 15%) and usually require the corporation to issue stock warrants as consideration for the facility.

Mezzanine lending is available to corporations that are relatively mature. They have typically done multiple rounds of equity financing and wish to avoid more equity financings to mitigate dilution. With mezzanine financing, the lender has the right to convert its debt into equity if repayment does not occur, often giving the lender a pathway to control the corporation should payment not occur. The benefit to the corporation is that these lenders often are willing to subordinate their positions to other commercial debt and the capital provided is often enough to bridge the company to a major event, like an acquisition or an IPO where repayment occurs. Like venture debt, mezzanine debt usually carries heavy interest rates and often includes stock warrants.

Annex # 9 – Helpful Websites for your Journey

There have been references to useful websites throughout the Establishing a US Presence roadmap and this Annex. For your convenience we have a compiled a list of these websites below:

Websites for obtaining a FEIN:

- Form SS-4: https://www.irs.gov/pub/irs-pdf/fss4.pdf

- Submitting FEIN application: https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online

Websites to determine required business license and permits, and methods for obtaining them:

- The state of California has a very helpful website that lists the needed permits and licenses, depending on the city and county of the business: http://www.calgold.ca.gov/

- The state of Delaware has a "One Stop Business Registration and Licensing System" website: https://onestop.delaware.gov/osbrlpublic/

Formation and Registration forms:

- The state of California provides samples and forms of all formation documents, as well as an explanation of all applicable fees and procedures: http://www.sos.ca.gov/business-programs/business-entities/forms

  - In order to form a corporation in California, you should complete at a minimum the form Articles of Incorporation: http://bpd.cdn.sos.ca.gov/corp/pdf/articles/arts-gs.pdf
  - In order to form a LLC in California, you should complete the form Articles of Organization: http://bpd.cdn.sos.ca.gov/llc/forms/llc-1.pdf
  - For foreign corporations wishing to qualify in California, please see the form Statement and Designation by Foreign Corporation: http://bpd.cdn.sos.ca.gov/corp/pdf/foreign/s&dc-sn.pdf
  - For foreign LLCs wishing to qualify in California, please see the form Application to Register a Foreign Limited Liability company: http://bpd.cdn.sos.ca.gov/llc/forms/llc-5.pdf

- The state of Delaware also provides samples of all formation documents, as well as an explanation of all applicable fees and procedures: https://corp.delaware.gov/corpforms.shtml

Websites with private placement resources:

- Annotated preferred stock financing documents can be viewed at the National Venture Capital Association's website: http://nvca.org/resources/model-legal-documents/
- Open-sourced "series seed preferred stock" financing documents can be accessed here: http://www.seriesseed.com/
- Hybrid SAFE instruments information can be accessed at Y Combinator's website: https://www.ycombinator.com/resources/#documents
- Convertible promissory note and hybrid "KISS documents" can be access at the 500 Start-ups website: http://500.co/kiss/

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