**Focus Groups – Financing & Controlling Corporate Entities**[1]

**Group A:** Sosha, Chandler, Alexis, Shane
**Group B:** ***See Financing & Controlling Non-Corporate Entities***
**Group C:** Ted, Nicole, Peter
**Group D**: ***See Financing & Controlling Non-Corporate Entities***

**Objectives of the Clients regarding financing & control**

Two promoters, Alice and Andy, have designed a new and powerful algorithm for searching internet web sites. They will be forming a corporation ("TouchSearch, Inc."). They need **$10 million** in seed money to start up and sustain the business for the first two years. Alice and Andy are anticipating that, after two years, they will sell the business, or seek a growth-oriented second round of financing.

Alice and Andy are each contributing $250,000 in cash + $750,000 in I.P. and pre-formation services. Alice and Andy will be employed by the corporation and receive appropriate compensation packages for the work they will perform. Alice and Andy need to retain substantial control over the management of the entity. There will be 8 "outside investors," all of whom are wealthy, sophisticated and willing to contribute $1 million in cash each.

The 10 shareholders (Alice, Andy and 8 outside investors) will each own 1/10th one-tenth of the equity of the corporation but the outside investors will receive priority rights to payment with regard to both distributions of profits and proceeds from the sales of assets. The eight outside investors will have voting rights with respect to fundamental decisions such as mergers, acquisitions or other major corporate decisions but Andy and Alice will have the rights to manage the general affairs of the corporation.

**Discuss:**

The Non-tax pros and cons: What are the benefits and detriments of using this type of format for a corporate financing plan. Consider factors such as:

- Control objectives
- Stability of corporate shield from personal liability
- Ease of *borrowing* money from a commercial lender
- Ease of raising additional *investment* capital from other sources
- Types of consideration for shares
- Ease of repayment of principal to investors
- Assuring large cash investors a priority of distribution in the event of sale or liquidation of the corporation.
- Advantages/disadvantages of equity over debt

1. This assignment is from Page 219 in Chapter 5.

*continued* ➜

- Advantages/disadvantages of debt over equity
- Advantages/disadvantages of preferred stock
- Employment Agreements for Alice & Andy
- *Possible re-classification or subordination of debt under In re Cold Harbor*

<u>The tax pros and cons</u>: What are the benefits and detriments of using this type of format from a tax viewpoint. Consider factors such as:

- The availability of Subchapter S status
- The tax consequences if the corporation is successful and principal is returned to investors.
- The tax consequences if the corporation is unsuccessful.
- Risks of re-classification of debt principal or salaries or lease payments as "dividends"
- The tax consequences to individual investors upon initial financing of the corporation.

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**Group A: <u>A mix of: (i) one class of common voting stock, and (ii) debt.</u>**

Both equity contribution and loans by investors to the corporation. Investors contribute cash, property, services and receive distributions of stock. They also make loans to the corporation and receive promissory notes (with, perhaps, a *commercial* loan for additional cash for operations).

**Group C: <u>A mix of: (i) common voting stock, and (ii) preferred stock.</u>**

Some investors receive preferences with respect to distributions of profits and upon liquidation.

**All of the above coupled with: (i) employment contracts with; and/or, (ii) leases/licenses of property by promoters to the corporation.**