

Technology Transfer Tactics™



The monthly advisor on best practices in technology transfer

Beware of COI and tax issues

LLCs can be smart for university start-ups, but only if you know the risks

Faculty start-ups have a few different options when it comes to forming a corporation, and the limited liability corporation (LLC) can be appealing. It has favorable aspects for entrepreneurs and it can be smart for universities that wish to take equity in the company, but there are potential complications to consider before making a decision.

University faculty are not likely to be up on the ins and outs of corporate structures, so tech transfer leaders should be ready to explain the basics and help walk them through the decision making process, says **Christopher F. Wright**, JD, shareholder with the McCausland Keen & Buckman law firm in Devon, PA. And from the university's perspective, he stresses, that decision has critical implications that must be thought through in each case.

"It's really easy for a licensing officer to forget to look at whether this start-up is going to be an LLC or a C-corporation. It's going to cause significant differences in how that licensing deal is done, so it's a matter to address up front," he says. "They don't think through the tax issues at a macro level. That ball gets dropped a lot."

Part of the decision will come down to the appetite of the university administration for taking an equity role in start-ups versus only being a licensor, says **K. Lance Anderson**, JD, an attorney with the Dickinson Wright law firm in Austin, TX, who previously directed the TTO at Texas Tech University. Some universities will settle on a hybrid in which they license the intellectual property but also hold equity in the start-up.

"That sounds good but sometimes it creates additional complexities. Taking a position where you're a licensor and a shareholder in an LLC

means there are inherent conflicts, a potential misalignment of interests. On one hand you're holding rights on which you can assert a default in the company, but that's a company in which you're a partner. You're kind of fighting against yourself at some point."

Unlike a straight license agreement, taking an equity position in a start-up also can create a "significant financial interest," a legal term that can affect the integrity of ongoing research, Anderson notes. "That is a manageable conflict of interest, but in some instances and especially when human subjects are involved, that conflict can be such that you have a real issue," he cautions. "This can come down to the goals of the administration and the university. Do they feel strongly enough about supporting entrepreneurial efforts to effectively manage these issues?"

LLCs a natural fit

LLCs are a natural first option to consider because they provide limited liability protection to their owners; the individuals are not personally responsible for the business debts and liabilities of the company, whereas in a sole proprietorship or general partnership the owners and the business are legally considered the same. That leaves personal assets vulnerable if the business falters, so the protection offered by an LLC immediately seems appealing to start-ups, especially for faculty with no prior experience in forming their own business.

The other common option is the C-corporation, which allows the sale of stocks and unlimited shareholders.

The LLC is the easiest to establish in many

cases, but it is not always the right choice, says **John Blake**, CPA and partner at New Jersey-based accounting and advisory firm Klatzkin & Company.

“If the company is going to look for private investment from parties outside of the university to fund operations and the company does not want to give up equity, then a C-corporation may be worth considering,” Blake says. “Whether an LLC is the right choice really depends on the goals of the founders. LLCs definitely have their place and, based on the simplicity and flexibility of LLCs, they could work well in this type of structure for a university start-up.”

Tax issues abound

Much of the consideration when determining start-up structure from a TTO perspective needs to be tax-driven, Anderson says. When starting any company and looking at the entity choices, the tax considerations are some of the first to consider because they can drive you in one direction or another, he says

There are potential tax benefits as well as risks, but it would be a mistake to assume that an LLC is the right decision for all start-ups, Wright says. In some cases, for example, that structure would complicate the university’s relationship with the business or be detrimental to the university.

“The trend for a number of years has been to do more start-ups as LLCs because you have one level of taxation, private investors may be able to use the passive losses, and a whole host of other reasons,” Wright says. “But most universities have not considered some of the peculiarities for them with doing equity licenses with LLCs rather than a traditional C- corporation. A lot of universities have stepped into an LLC without thinking things through.”

Under an LLC, the university still creates a license agreement and negotiates equity terms in a separate agreement, Wright notes. Some functions of the LLC’s relationship with the university will be dictated by state laws on issue such as investor rights and income distribution.

Beware the UBIT

Much of the potential difficulty with LLCs stems from the fact that many tech transfer

offices operate in a non-profit environment, Wright says. A major concern there is the risk of unrelated business income tax (UBIT).

When a nonprofit gains income from business outside its normal activities, it can incur the UBIT, he explains. “That could be anything from renting out the university stadium for a rock concert to other things that don’t go to the core activity of a university,” Wright says. “The potential problem for a tech transfer office working with an LLC is that once the company starts making money by selling widgets or services, revenue from the widgets or services passes through the university as a direct member and will be clearly unrelated to the university’s underlying charitable purpose. That creates the potential for the UBIT liability.”

Universities generally try to avoid UBIT liability -- certainly no one likes to pay additional taxes. But as Anderson notes, it’s more complicated than simply paying a tax on any earning. UBIT liability is determined on an aggregate basis and not on the basis of individual transactions, Wright explains. The UBIT liability is not assessed on each individual activity that is outside the normal scope of the university’s purpose but by combined effect of all such activities.

“That’s why you have to partner with other areas of the university administration to determine whether the university is generally in a net loss position or a net gain position from these activities, to see how sensitive the university is going to be to UBIT issues. Someone from the CFO’s or treasurer’s office needs to help you under the university’s macro position regarding UBIT issues,” Wright says. “I have university clients that are extremely sensitive and I have others that shrug their shoulders and say they’re always going to be in a net loss position so they’re fine with the LLC as long as you keep them informed of what’s going on.”

Even when there is the risk of paying the UBIT with an LLC, the university may choose to accept that risk because the potential benefit from the partnership is so high, Wright notes. In other situations the university may require the company to form a C-corporation, or the school may take a warrant in the LLC instead of a direct membership. The warrant agreement gives the university the right to buy or sell equity at a certain price for a specified time.

Joint venture issues

A university accepting an LLC membership interest would be technically participating as a partner in a joint venture, Wright notes, and that brings its own risks and complications. The transaction would be subject to the university's joint venture policy, and doing business with the LLC creates institutional risk. The university's state and federal exemptions can be at risk, along with its bond status, Wright says.

"I'm sure the joint venture policy at most universities was not written in consideration of tech transfer deals, so it may end up being a square peg in a round hole when you look at the policy and try to apply it," Wright says.

"Someone needs to look it from the university's perspective and look for conflicts."

The documents that create the corporation also can be complex and require extensive review by the university, Wright says. In a C-corporation, there are multiple documents creating the entity, including bylaws, a stockholder agreement, and instruments required by the state. For an LLC most issues are addressed in a single document commonly called an operating agreement.

The operating agreement is a contract among all members of the entity and the entity itself. It can be a complex, long document, and the university must understand the nuances of the operating agreement, Wright says.

"You need several layers of review. The corporate review looks at the nuances of the deal, how it's structured, and the financial matters," he says. "But you also need a tax review to make sure you understand how allocations and distributions are handled, including UBIT concerns. This is burdensome, more complex, and it takes a longer time to put the deal together, so you have to know going in that these deals are a little messier than the traditional C-corp deals."

LLC can be pricey

In a joint presentation with Wright at an Association of University Technology Managers meeting, **Robert B. McGrath**, PhD, senior associate vice provost at Drexel University in Philadelphia, PA, noted that an LLC can bring much higher legal fees than other options because it is so customizable and universities try

to take advantage of that for their own benefit.

The legal review required with an LLC can drive the cost to as much as \$20,000, compared to the more typical \$2,500 for a C-corporation, McGrath said. Agreeing to a term sheet, in which both parties accept standard material terms and conditions of a business agreement, can reduce the cost of an LLC to more like \$10,000. The university could reduce that cost even more by creating a boilerplate LLC operating agreement spelling out its preferred terms and creating a basic document for the entrepreneur. That approach could reduce the legal fees to about \$5,000, he said.

Simplified and standardized agreements also can make the start-up more attractive to outsiders, Anderson notes. If the start-up will be seeking angel investors, for instance, don't try to do anything innovative with the corporate structure.

"Investors will want to see something they've worked with before, something that is standard and they're comfortable with. I've seen university deals go sideways because of funky provisions in the corporation," Anderson says. "Universities are notorious for not negotiating because of their public status, so they load agreements with all these approval requirements and restrictions that end up doing more harm than good."

Universities throw in clauses that are meant to protect their interests, but further down the road potential investors may see those voting rights or other provisions as unnecessarily holding back the company's potential, he observes. "They'll ask why those provisions are in there, and why they don't get the same rights," Anderson explains. "Even if you find a way to placate them, it's an unnecessary obstacle for the company, and one for which the university probably didn't gain much of anything that's meaningful."

Don't skimp on review

The one thing not to be overly frugal about, Blake advises, is in professional review of accounting and tax issues in whatever operating structure you choose. "Money spent on reviewing the operating agreement is money well spent so it may not be the best area to cut corners," he says. "The operating agreement can basically determine if the university will have to report taxable income or not."

The tech transfer office must be cautious when providing entrepreneurs advice on LLCs and other start-up options, Wright adds. Advise faculty members that the TTO and the university do not represent the company, that they need their own counsel.

“What you can tell them is that you are making available to them some tools that may help them and their counsel structure a deal that will be straightforward and conducive to moving along smoothly with the university,” Wright says. “You can suggest that this is how you like to do

business with start-ups, but you need to be clear that they need their own counsel. If you don’t proactively deal with that issue, you can get into trouble when people are under the misconception that because you’re offering advice and guidance, that means you’re representing them in a legal sense.”

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