

Start-Up Funding: Avoiding the Pitfalls and Positioning the Company

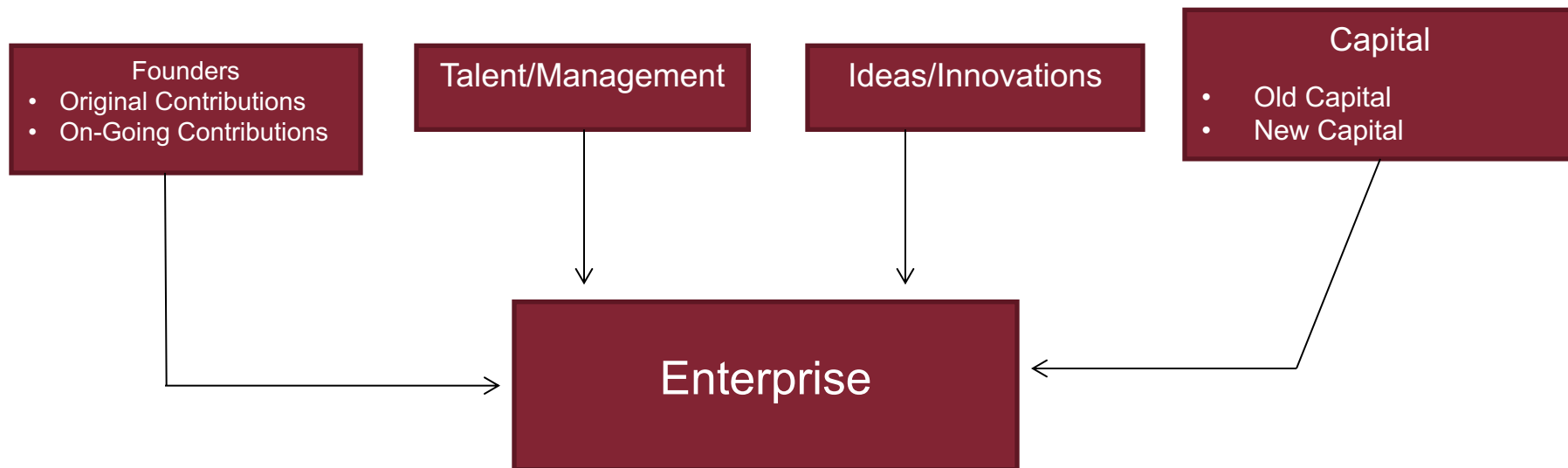
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Agenda

- Introduction
- Some Challenges and Alternatives
- Applicable Laws
- The Security (debt, stock, convertible debt/SAFE)
- Commonly Discussed Terms
- Top 10 (or so) Pitfalls
- Questions and Answers (But Don't Wait)

The Challenge – Balance Competing Interests



Consider Alternative Sources of Capital

- Customers (e.g., tests/pilots)
- Bootstrap
- License Fees
- Public financing/grants (e.g., SBIR)
- Debt
- Crowdfunding

Funding Cycle

- Incubators/Accelerators (e.g., Project Olympus, Idea Foundry, Alpha Lab, Ascender, LifeX)
- Public or quasi-public funds (e.g., Innovation Works)
- **Friends and Family**
- Angels
 - **Early Stage**
 - Later Stage
- Venture Capital/Strategic Investors
 - **Early Stage**
 - Later Stage
- Public Markets





Securities Act of 1933

- Broad definition of Securities:
 - “Any note, stock, bond, debenture, evidence of indebtedness...investment contract...”
- Excludes short term note (typically less than 9 months)
- Securities Act – Registration

In general: Registration is required with the Securities and Exchange Commission for the sale of securities (e.g., an S-1)

- Registration is expensive and time-consuming
- **Objective: Avoid registration**

Exemption – Private Offering

- Effect of Exemption
 - Exemption from Registration Process
 - **No Exemption** from:
 - Notice Filing
 - Fraud provisions of the Securities Act



Safe Harbor: Rule 506 of Regulation D

Rule 506(b)

- Unlimited number of Accredited Investors
- Up to 35 Persons who are not Accredited Investors

For Unaccredited Investors, detailed information must be provided

- “Reasonable belief” regarding Accredited Investors

Accredited Investors

- Natural person who, together with spouse, has a net worth of more than \$1,000,000 (excluding residence); or
- Natural person with individual income of at least \$200,000 (or joint income with spouse of \$300,000) in each of the two most recent years and has a reasonable expectation of the same income in the current year; or
- Corporation or partnership not formed for the specific purpose of investing with assets in excess of \$5,000,000; or
- Any director, executive officer or general partner of the issuer

Common Requirements for Exemption:

- No general solicitation or general advertising (advertisement, article or media broadcast (hint: no website ads)) [other than New Rule 506(c)]
- Reasonable belief that the purchaser is purchasing for purposes of investment and not resale (hint: get a representation)
- File a Form D (no later than 15 days after the first sale)



Rule 506(c)

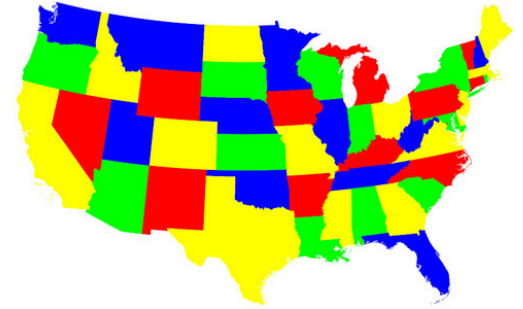
- Issuers must choose between Rule 506(b) and Rule 506(c)
- Eliminates prohibition on General Solicitation
 - This includes websites!
- 2 Key requirements
 - Purchasers must all be Accredited Investors
 - Issuers must take “reasonable steps” accredited investor status



Rule 506(c) – Heightened Verification

- Factors:
 - Nature of Purchaser (e.g., individual or institution)
 - Amount and type of information that the issuer has about the investor
- Check the box is insufficient
 - Burden is on issuers





Don't Forget about the States!

- State-by-state regulation
- National Securities Markets Improvements Act of 1996
 - Preempts state regulation
 - 4(a)(2) exemption – Rule 506
 - Requires notice and filing fees (concession to states)
- Check states

Bottom Line

- Rely on 506(b) or 506(c)
- Decide between 506(b) and 506(c) early
- Don't advertise until decision is made



Reason for Compliance

- Purchaser remedies – rescission
- Future potential investors/purchaser
- Insurance Policy



Disclosure

- Requirements
- Private Placement Memorandum
 - Protection for “fraud” claims under Securities Act
 - Material misrepresentation
 - Omit to state a material fact necessary to make the statements made not misleading
 - Professionalism



Key Elements of Private Placement Memorandum (or short form)

- Description of Issuer
- Business plan
- **Risk factors**
- Subscription procedures
- **Conflicts of interest**
- Financial statements
- Capitalization
- Exhibits (e.g., organizational documents)
- In general – “Material” information

Type of Security

Secured Debt

Unsecured Debt

Convertible Debt

Preferred Equity

Common Equity

Type of Security

- Debt
- Convertible Debt/SAFE
- Preferred Equity
- Common Equity

Debt

- Benefits
 - Simple
 - Non-dilutive
 - No valuation
- Downside
 - **Must be paid**
 - Interest
 - Balance sheet implications



Debt from Investor Perspective

- Preference in payment
- Potentially secured
- Fixed date for return of investment
- **No upside**
- Interest taxable as ordinary income

COLLATERAL

- Personal Guarantees
- Security Interest
 - Pledged Assets
 - Remedies

Common Equity

- Benefits
 - Simple
 - Aligns interests
- Downside
 - Requires valuation
 - Likely lower price

Common Equity – Investor Perspective

- Simple – Aligns interest
- Investor gets “Upside”
- No preference
- Highest risk capital
- No typical preferred protections
 - Price protection
 - Dividends
 - Approvals

(Light) Preferred

- Description
 - Liquidation Preference
 - Dividend (not your Disney-type dividend) (hidden dilution)
 - Fewer control features than typical preferred
- Benefits
 - Attracts investors
- Downside
 - Complexity
 - Potential impact on future investors
 - Requires a valuation
 - May not align interests

Liquidation Preferences

- Definition of Liquidation
- **Participating Preferred:** Investor receives investment (plus accrued dividends) and participates on a pro rata basis
- **Non-Participating Preferred:** Investor receives the greater of (1) investment plus accrued dividends or (2) proceeds on a pro rata basis

Example of Participating Preference

\$2M Investment

\$3M Pre-Money Valuation

Founders/Employees 60%

Venture Capital 40%

Participating

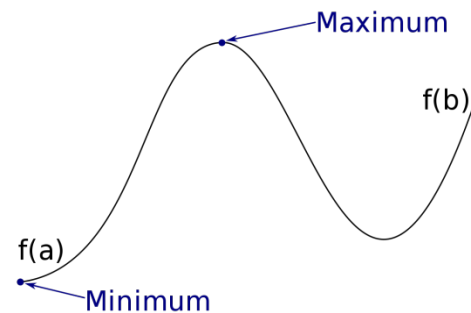
	<u>\$2M</u>	<u>\$5M</u>	<u>\$10M</u>
Founders/Employees	\$0M	\$1.8M	\$ 4.8
Venture Capital	\$2M	\$3.2M	\$ 5.2

Non-Participating

	<u>\$2M</u>	<u>\$5M</u>	<u>\$10M</u>
Founders/Employees	\$0M	\$3.0M	\$ 6.0
Venture Capital	\$2.0M	\$2.0M	\$ 4.0

Convertible Debt

- Description
 - Convertible to equity upon trigger events
 - Sometimes convertible into new security
 - Sometimes convertible into common stock
 - Mandatory vs. voluntary conversion
 - Discount to investment price (e.g., 20%)
 - Avoid fancy conversion terms
 - Base price in case of no additional investment
 - ***Cap on valuation***



“Simple Agreement for Future Equity”

- Discount to Next Round – similar to convertible debt
- Sale of Company – paid or converted
- Dissolution- Paid before equity
- No obligation to repay at maturity

Example of Cap

- \$2M VC Investment
- \$5M Pre-Money Valuation
- \$500,000 F&F

	20%	\$2M
	<u>Discount</u>	<u>Cap</u>
Founders	60%	51%
F&F	11%	20%
VC	<u>29%</u>	<u>29%</u>
	100%	100%

Note: unintended consequence of different prices

Pre-Money v. Post-Money

- Is the SAFE/Convertible Debt in or out of the valuation/cap?
 - If included – Post-money
 - If excluded – Pre-money
- Post- Money fixes the percentage for SAFE/Convertible Debt holders
 - Investor is NOT diluted for its debt
 - Investor is NOT diluted for additional convertible debt
- Pre-Money benefits the Company
- Note: This should NOT include the priced round

Example of Pre-Money/Post-Money

- \$1M in collective SAFE's
- \$5M cap

Pre-Money

Common	1,000,000	83.33%
SAFE	200,000	16.67%
Total	1,200,000	100.00%

$\$5\text{M}/1,000,000 = \5.00 per share

Post-Money

Common	1,000,000	80.00%
SAFE	250,000	20.00%
Total	1,250,000	100.00%

Note: $\$1\text{M}/\$5\text{M} = 20\%$

Convertible Debt/SAFE

- Benefits
 - Common
 - Avoids the “valuation issue” (sort of...)
 - Simpler
- Downside
 - Conversion price unknown (Risk of low valuation)
 - Usually accrues interest (can be additional dilution)
 - Debtholders can have interests that are not aligned with common

Factors In Valuation

- Availability of capital
- Amount of raise and dilution
- Type of investors
- Anticipated growth from investment
- Future plans for financing

Valuation

- Hard to value at this point
- Alpha Lab - \$25,000 for 5% common (\$500,000 post-money valuation)
- Alpha Gear - \$50,000 + incubator for 9% common (\$500,000 pre-money)
- Ascender - 5% for incubator
- Caution of giving up over 10% of the Company for an angel round (so, if you are raising \$100,000, post-money of \$1M)

Example 1 (Priced Round) Initial

	<u>Shares</u>	<u>Percentage Ownership</u>
Founder	1,000,000	100%

Example 1 Employee Equity

	<u>Shares</u>	<u>Percentage</u>
Founder	1,000,000	85%
Employees	<u>176,471</u>	<u>15%</u>
Total	1,176,471	100%

Example 1 Friends and Family Round (Priced Round)

- \$250,000 Friends and Family
- \$1,000,000 Pre-Money Valuation

Founder	1,000,000	68%
Employees	176,471	12%
F&F (\$0.85 per share)	<u>294,118</u>	<u>20%</u>
Total	1,470,589	100%

Example 1 Series A Round

- \$2M Investment
- \$3M Pre-Money Valuation

Founder	1,000,000	41%
Employees	176,471	7%
F&F	294,118	12%
VC (\$2.04 per share)	<u>979,608</u>	<u>40%</u>
Total	2,450,197	100%

Note: VC will want employees' amount increased
Note Control

Example 2 Initial

	<u>Shares</u>	<u>Percentage</u>
Founder	1,000,000	85%
Employees	<u>176,401</u>	<u>15%</u>
Total	1,176,471	100%

Example 2 (Convertible Debt)

- \$250,000 Friends and Family; convertible debt-20% discount
- Series A – \$2M investment at \$3M pre-money valuation

Founder	1,000,000	46%
Employees	176,401	8%
F&F (\$1.82 per share)	136,791	6%
Series A (\$2.28 per share)	<u>875,461</u>	<u>40%</u>
Total	2,188,653	100%

Comparison of Priced Round v. Convertible Debt

	Example 1 (Priced Round)	Example 2 (Convertible Debt)
Founder	41%	46%
Employees	7%	8%
F&F	12%	6%
Series A	<u>40%</u>	<u>40%</u>
Total	100%	100%

Example 3

Too Much Convertible Debt

- \$1,000,000 Friends and Family; convertible debt (20% discount)
- Series A – \$2M investment at \$3M pre-money valuation

Founder	1,000,000	30%
Employees	176,401	5%
F&F	840,286	25%
Series A	<u>1,344,458</u>	<u>40%</u>
Total	3,361,145	100%

Comparison

	Example 1 (\$250,000 Priced Round)	Example 2 (\$250,000 Convertible Debt)	Example 3 (\$1M Convertible Debt)
Founder	41%	46%	30%
Employees	7%	8%	5%
F&F	12%	6%	25%
Series A	<u>40%</u>	<u>40%</u>	<u>40%</u>
Total	100%	100%	100%

Control Issues

- Three Layers of “Influence”
- Approval Rights (Board or investor)
 - Day-to-day
 - Fundamental transactions (sale of the company)
 - Future financings
 - Employee equity
- Board Representation
 - Board seat
 - Board control
 - Observer



Commonly Discussed Terms

- Reverse-Vesting for Founders
- Founder Employment Agreements/Restrictive Covenants
- Drag-Along Rights
- Anti-Dilution Protection
- Information Rights
- Shareholder Arrangements
 - Agreement to execute a Shareholder Agreement (for note holders)

Bottom Line

- Common or Convertible Debt
- Minimize the angel funding – it is likely to be expensive money
- Minimize control of investor
- Keep it simple

Top Ten (or so) Mistakes

- Over-Promise – Under-Deliver
- Waste Early Money
- Disrespect Capital
- Target Old Ladies, Pensions and Thanksgiving dinner companions
- Poison the Company
 - Not enough stock for management
 - Give away veto rights, rights of first refusal or exclusivity
- Severely underestimate the cost and time
- Leave the numbers to somebody else
- Give up control (legally or mentally)



Top Ten (or so) Mistakes (cont.)

- Under-capitalize
- Ignore securities laws
- Engage a personal injury lawyer