Agenda

- Introduction
- The Challenges
- Applicable Laws (Including the JOBS Act)
- The Security
- Commonly Discussed Terms
- Top 10 (or so) Pitfalls
- Questions and Answers (But Don’t Wait)
The Challenge – Balance Competing Interests

Founders
- Original Contributions
- On-Going Contributions

Talent/Management

Ideas/Innovations

Capital
- Old Capital
- New Capital

Enterprise
Consider Alternative Sources of Capital

- Customers
- Bootstrap
- License Fees
- Public financing/grants
- Debt
- Crowdfunding
Funding Cycle

- **Incubators** (e.g., Project Olympus, Idea Foundry, Alpha Lab, Thrill Mill)
- **Public or quasi-public funds** (e.g., Innovation Works, Pittsburgh Life Sciences Greenhouse)
- **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
Exemptions from Registration

- Section 3(b) – Small Offering
- Section 4(a)(2) – Private Offering
- Effect of Exemption
  - Exemption from Registration Process
  - **No Exemption** from:
    - Notice Filing
    - Fraud provisions of the Securities Act
Safe Harbor: Regulation D

Rule 506(b) (under Section 4(a)(2)):
- 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

Rule 504 (under Section 3(b)):
- The aggregate offering price can not exceed $1,000,000
- Unlimited 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
Accredited Investors (cont.)

- Definition likely to change
- SEC required to review accredited investor status every 4 years
- With inflation
  - Income: $500,000/$740,000
  - Net Worth: $2.5 Million
- Balancing competing interests (chilling v. protection)
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)
Jumpstart On Business Startups Act (JOBS Act)

- Enacted on April 5, 2012
- Intent: Minimize Regulations of Private Offering of Securities
New Rule 506(c)

- Eliminates prohibition on General Solicitation
- 2 Key requirements
  - Purchasers must all be Accredited Investors
  - Issuers must take “reasonable steps” to verify accredited investor status
- Issuers must choose between Rule 506(b) and Rule 506(c)
New Rule 506(c) – Verification Obligations

- Factors:
  - Nature of Purchaser (e.g., individual or institution)
  - Amount and type of information that the issuer has about the investor
  - The terms of the offering (particularly a minimum investment)
- Check the box is insufficient
  - Burden is on issuers
New Rule 506(c) – Non-Exclusive and Non-Mandatory Methods of Verification

- Income Basis
  - IRS Forms for two most recent years
  - Written representation from investor for current year
- Net Worth Test
  - Assets – Bank statement, brokerage statement, statements of securities holding
  - Liabilities – Consumer report from at least 1 national consumer reporting agency
Third Party

- Written confirmation from professional that the professional has taken reasonable steps to verify that the investor is an accredited investor within the prior 3 months
  - Registered broker-dealer
  - Registered investment advisor
  - Attorney
  - CPA
Blue Sky Laws (State Requirements)

- State-by-state regulation
- National Securities Markets Improvements Act of 1996
  - Preempts state regulation
  - 4(a)(2) exemption – Rule 506
  - Not Rule 504
  - Still requires notice and filing fees (concession to states)
- Check states – Example: NY
Bottom Line

- Rely on 506(b) or 506(c) and limit to Accredited Investors; or
- Rely on 504 (under $1,000,000) and find state exemption
- Decide between 506(b) and 506(c) early
- Don’t advertise until decision is made
- Note: Potential impact of future change in definition of Accredited Investor
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
Reason for Compliance

- Purchaser remedies – rescission
- Future potential investors/purchaser
- Insurance Policy
Crowdfunding (e.g., Kickstarter)

- **Origins**
- **Sidesteps securities laws – not a sale of a “Security”**
- **Example – Prevail Travail – Interactive Restaurant (raised $75,000)**
  - **Rewards**
    - Fast Pass
    - Cooking class
    - Tickets for dinner
    - Tickets to opening party
    - 2014 Sexy Chef Calendar
Other Examples

- Dobot Arm: High precision robot arm for residential use (e.g., soldering)
- $339
- Basic version robot arm with clipper, sucker, laser head
- $233,288 of $36,000 goal
Other Examples (cont.)

- Schell Games: Puzzle Clubhouse – Crowd – designed games
  - $1 – Founder clubhouse profile + desktop background
  - $25 – 1 year membership
- $11,403
Other Examples (cont.)

- Walter’s Coffee Roastery – Breaking Bad inspired coffee lab opening in Brooklyn – combining science and coffee:
  - $10 – Sample bag, postcard, stickers
  - $20 – Plus Mug
  - $30 – Tote Bag
- $7,855 of $65,000 (21 days to go)
Potential Effect of JOBS Act - Securities

- A new exemption
- Regulations long overdue
- Sale to non-accredited investors through registered intermediaries
- Limited on amount: $1,000,000
- Limited on investment: depends on net worth and income
  - Under $100,000 annual income or net worth - greater of $2,000 or 5% of annual income or net worth
  - $100,000 + annual income or net worth - greater of 10% of annual income or net worth (maximum of $100,000)
Potential Effect of JOBS Act (cont.)

- Intermediary must be registered
  - Broker
  - Funding Portal
- Each Intermediary (funding portal):
  - Register with SEC
  - Ensure that each investor:
    - Confirms that it understands the risk
    - Answer questions confirming that it understands the risk
- Takes measures to reduce risk of fraud
Potential Effect of JOBS Act (cont.)

- Disclosure
  - SEC
  - Investor
    - Note:
      If less than $100,000: tax returns and internally-generated financial statements
      If more than $100,000: reviewed financial statements
      If more than $500,000: audited financial statements

- Restrictions on Resale
  - No resale to unaccredited investor for 1 year
  - More to come

- “It’s not the SEC that killed crowdfunding – it was Congress”, Joan Hemingway - University of Tennessee
Crowdfunding
- Step in right direction
- Not in effect yet – no regulations (soon)
- Public disclosure and requirements may be too burdensome
- Stay tuned
Type of Security

- Secured Debt
- Unsecured Debt
- Convertible Debt
- 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
  - Less expensive
  - 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)
  - Fewer control features than typical preferred

- **Benefits**
  - Attracts investors

- **Downside**
  - Complexity
  - Separate class of stock (hidden rights)
  - Potential impact on future investors
  - Valuation
  - May **not** align interests
Liquidation Preferences – Downside Protection for Investors

- 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

<table>
<thead>
<tr>
<th>Founders/Employees</th>
<th>Venture Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>60%</td>
<td>40%</td>
</tr>
</tbody>
</table>

Participating

<table>
<thead>
<tr>
<th></th>
<th>$2M</th>
<th>$5M</th>
<th>$10M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders/Employees</td>
<td>0</td>
<td>$1.8M</td>
<td>$4.8</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>$2M</td>
<td>$3.2M</td>
<td>$5.2</td>
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</tbody>
</table>

Non-Participating

<table>
<thead>
<tr>
<th></th>
<th>$2M</th>
<th>$5M</th>
<th>$10M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders/Employees</td>
<td>$1.2M</td>
<td>$3.0M</td>
<td>$6.0</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>$0.8M</td>
<td>$2.0M</td>
<td>$4.0</td>
</tr>
</tbody>
</table>
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%)
  - Fancy conversion terms (avoid)
  - Base price in case of no additional investment
  - Cap on valuation/minimum valuation
Convertible Debt (cont.)

- **Benefits**
  - Common
  - Avoids the “valuation issue” (sort of…)

- **Downside**
  - Conversion price unknown (Risk of law valuation)
  - Usually accrues interest (can be additional dilution)
  - Debt holders 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)
- Thrill Mill - 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

**Initial**

<table>
<thead>
<tr>
<th>Founder</th>
<th>Shares</th>
<th>Percentage Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>100%</td>
</tr>
</tbody>
</table>
## Example 1
### Employee Equity

<table>
<thead>
<tr>
<th></th>
<th>Shares</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>85%</td>
</tr>
<tr>
<td>Employees</td>
<td>176,471</td>
<td>15%</td>
</tr>
<tr>
<td>Total</td>
<td>1,176,471</td>
<td>100%</td>
</tr>
</tbody>
</table>
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 ($.85 per share) 294,118 20%
  Total 1,470,589 100%
Example 1
Series A Round

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

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>41%</td>
</tr>
<tr>
<td>Employees</td>
<td>176,471</td>
<td>7%</td>
</tr>
<tr>
<td>F&amp;F</td>
<td>294,118</td>
<td>12%</td>
</tr>
<tr>
<td>VC ($2.04 per share)</td>
<td>979,608</td>
<td>40%</td>
</tr>
<tr>
<td>Total</td>
<td>2,450,197</td>
<td>100%</td>
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</tbody>
</table>

Note: VC will want employees’ amount increased

Note: Control
### Example 2

**Initial**

<table>
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<th>Percentage</th>
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<tbody>
<tr>
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<td>1,000,000</td>
<td>85%</td>
</tr>
<tr>
<td>Employees</td>
<td>176,401</td>
<td>15%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,176,471</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
Example 2
(Convertible Debt)

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

<table>
<thead>
<tr>
<th>Category</th>
<th>Shares</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>46%</td>
</tr>
<tr>
<td>Employees</td>
<td>176,401</td>
<td>8%</td>
</tr>
<tr>
<td>F&amp;F ($1.82 per share)</td>
<td>136,791</td>
<td>6%</td>
</tr>
<tr>
<td>Series A ($2.28 per share)</td>
<td>875,461</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,188,653</td>
<td>100%</td>
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</tbody>
</table>
### Comparison of Priced Round v. Convertible Debt

<table>
<thead>
<tr>
<th></th>
<th>Example 1 (Priced Round)</th>
<th>Example 2 (Convertible Debt)</th>
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<td>12%</td>
<td>6%</td>
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<tr>
<td>Series A</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>100%</strong></td>
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</tbody>
</table>
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

<p>| | | | |</p>
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</tr>
<tr>
<td>Employees</td>
<td>176,401</td>
<td>5%</td>
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</tr>
<tr>
<td>F&amp;F</td>
<td>840,286</td>
<td>25%</td>
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<tr>
<td>Series A</td>
<td>1,344,458</td>
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<tr>
<td><strong>Total</strong></td>
<td>3,361,145</td>
<td><strong>100%</strong></td>
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</table>
## Comparison

<table>
<thead>
<tr>
<th>Example 1 ($250,000 Priced Round)</th>
<th>Example 2 ($250,000 Convertible Debt)</th>
<th>Example 3 ($1M Convertible Debt)</th>
</tr>
</thead>
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<tr>
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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

- Anti-Dilution Protection
- Information Rights
- Shareholder Arrangements
  - Agreement to execute a Shareholder Agreement (for note holders)
  - Drag-along rights
  - Restrictions on transfer of stock
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.)

- Over-capitalize
- Under-capitalize
- Ignore securities laws
- Don’t align interests
- Engage a personal injury lawyer