Agenda

- Introduction
- 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

Enterprise
Alternative Sources of Capital

- Customers
- License Fees
- Public financing/grants
- Debt
- Bootstrap
- 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**
  - Early Stage
  - Later Stage
- **Strategic Investors**
- **Public Markets**
Applicable Laws

- Securities Act of 1933
- 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)
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
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
506(c) – Non-Exclusive and Non-Mandatory Methods of Verification (cont.)

- 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
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
    - Sexy Chef Calendar
Other Examples of Crowdfunding

- Schell Games: Orion Trail – A Science Fiction Space Adventure Game
  - $10 – Game + name in credits
  - $20 – Above + early access and sound track
  - $50 – Above + name a red shirt character
  - $75 – Above + get a red shirt
- $28,000 of $90,000 goal
Other Examples of Crowdfunding

- Qmote: Single – button water-resistant remote control which lets you perform actions on your phone
  - $15 – one Qmote device
  - $29 – two Qmote devices
  - $39 – three Qmote devices
  - $50 – five Qmote devices
- $120,599 (21 days to go) [of $20,000 goal]
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
Potential Effect of JOBS Act (cont.)

- Crowdfunding
  - Step in right direction
  - Not in effect yet – no regulations (soon)
  - Public disclosure and requirements may be too burdensome
  - Stay tuned
  - Move to Georgia or Kansas (Alabama, Indiana, Michigan, Washington, Wisconsin). More to come!
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
Preferred

- Description
  - Liquidation Preference
  - Dividend

- 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 PLUS

- 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 v. Non-Participating Preferred

- $3M Investment
- Pre-Money Valuation $4.5M

<table>
<thead>
<tr>
<th>Shares</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Option Pool</td>
<td>333,333</td>
</tr>
<tr>
<td>Investor</td>
<td>889,889</td>
</tr>
<tr>
<td>TOTAL</td>
<td>2,223,222</td>
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### Participating v. Non-Participating Preferred

<table>
<thead>
<tr>
<th></th>
<th>$3M Sale</th>
<th>$5M Sale</th>
<th>$10M Sale</th>
<th>$20M Sale</th>
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<tr>
<td><strong>Participating</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Preferred</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Founder (45%)</td>
<td>0</td>
<td>$ .9M</td>
<td>$3.15M</td>
<td>$7.65M</td>
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<tr>
<td>Option Pool (15%)</td>
<td>0</td>
<td>$ .3M</td>
<td>$1.05M</td>
<td>$2.55M</td>
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<tr>
<td>Investor (40%)</td>
<td>$3.0M</td>
<td>$3.8M</td>
<td>$5.80M</td>
<td>$9.80M</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$3.0M</td>
<td>$5.0M</td>
<td>$10.0M</td>
<td>$20.0M</td>
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<tr>
<td><strong>Non-Participating</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Preferred</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Founder (45%)</td>
<td>0</td>
<td>$1.5M</td>
<td>$4.5M</td>
<td>$9.0M</td>
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<tr>
<td>Option Pool (15%)</td>
<td>0</td>
<td>$ .5M</td>
<td>$1.5M</td>
<td>$3.0M</td>
</tr>
<tr>
<td>Investor (40%)</td>
<td>$3.0M</td>
<td>$3.0M</td>
<td>$4.0M</td>
<td>$8.0M</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$3.0M</td>
<td>$5.0M</td>
<td>$10.0M</td>
<td>$20.0M</td>
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<tr>
<td><strong>Participation Benefit</strong></td>
<td>0</td>
<td>$ .8M</td>
<td>$1.80M</td>
<td>$1.80M</td>
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</table>
Liquidation Preference Summary

- Participating Preferred costs the Founder the Founder’s percentage of the Preference (e.g., 60% of $3M = $1.8M)
- Downside protection (and more)
- Consider cap on participation
Dividends

- These are **Not** your “Blue Chip”/Disney dividends
- Amount – Dilutive [Note effect on preferences]
- Timing of payment – Typically on Liquidation
- Form of payment
  - Stock v. Cash
- Hidden Dilution
Effect of Dividends in Stock

- Dividends accrue at 8%, non-compounded, 5 years ($1.2M)

<table>
<thead>
<tr>
<th></th>
<th>Pre-Dividends</th>
<th>Percentage</th>
<th>Post-Dividends</th>
<th>Shares</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>45%</td>
<td>1,000,000</td>
<td>39%</td>
<td></td>
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<tr>
<td>Option Pool</td>
<td>333,333</td>
<td>15%</td>
<td>333,333</td>
<td>13%</td>
<td></td>
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<tr>
<td>Investor</td>
<td>889,889</td>
<td>40%</td>
<td>1,245,845</td>
<td>48%</td>
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<tr>
<td>TOTAL</td>
<td>2,223,222</td>
<td>100%</td>
<td>2,579,178</td>
<td>100%</td>
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</table>
Liquidation Rights

- Redemption Rights
  - Timing
  - Price
  - Effect on Company
- Force Sale
- Right to force going public
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
  - Potential cap on valuation
  - Potential minimum valuation [Good luck!]
  - Conversion on sale
Convertible Debt (cont.)

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

- Downside
  - Conversion price unknown
  - 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
(Priced Round)
Initial

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

<table>
<thead>
<tr>
<th></th>
<th>Shares</th>
<th>Percentage</th>
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<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><strong>Total</strong></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

<p>| | | |</p>
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>68%</td>
</tr>
<tr>
<td>Employees</td>
<td>176,471</td>
<td>12%</td>
</tr>
<tr>
<td>F&amp;F ($0.85 per share)</td>
<td>294,118</td>
<td>20%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>1,470,589</strong></td>
<td><strong>100%</strong></td>
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Example 1
Series A Round

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

<table>
<thead>
<tr>
<th></th>
<th>Shares</th>
<th>Percentage</th>
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<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>
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<tr>
<td><strong>Total</strong></td>
<td><strong>2,450,197</strong></td>
<td><strong>100%</strong></td>
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</table>

Note: VC will want employees’ amount increased
Example 2
Initial

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

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

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<thead>
<tr>
<th></th>
<th>Shares</th>
<th>Percentage</th>
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<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>
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<tr>
<td>F&amp;F ($1.82 per share)</td>
<td>136,791</td>
<td>6%</td>
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<tr>
<td>Series A ($2.28 per share)</td>
<td>875,461</td>
<td>40%</td>
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<tr>
<td>Total</td>
<td>2,188,653</td>
<td>100%</td>
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## Comparison of Priced Round v. Convertible Debt

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

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>30%</td>
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<tr>
<td>Employees</td>
<td>176,401</td>
<td>5%</td>
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<td>F&amp;F</td>
<td>840,286</td>
<td>25%</td>
</tr>
<tr>
<td>Series A</td>
<td>1,344,458</td>
<td>40%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>3,361,145</strong></td>
<td><strong>100%</strong></td>
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## Comparison

<table>
<thead>
<tr>
<th>Example 1</th>
<th>Example 2</th>
<th>Example 3</th>
</tr>
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<tbody>
<tr>
<td>($250,000 Priced Round)</td>
<td>($250,000 Convertible Debt)</td>
<td>($1M Convertible Debt)</td>
</tr>
<tr>
<td>Founder</td>
<td>41%</td>
<td>46%</td>
</tr>
<tr>
<td>Employees</td>
<td>7%</td>
<td>8%</td>
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<tr>
<td>F&amp;F</td>
<td>12%</td>
<td>6%</td>
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<tr>
<td>Series A</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Commonly Discussed Terms

- Maintenance Rights
  - End it
  - Require that they continue to be Accredited Investors
- Quick Resolution
- Waivable
- Proper exclusions (including requirement of new investor or strategic investor)
Commonly Discussed Terms

- Board Representation
  - Board seat
  - Board control
  - Observer
Commonly Discussed Terms

- Three Layers of “Influence”
- Approval Rights (Board or investor)
  - Day-to-day
  - Fundamental transactions (sale of the company)
  - Future financings
  - Employee equity
Commonly Discussed Terms

- Shareholder Arrangements
  - Agreement to execute a Shareholder Agreement (for note holders)
  - Drag-along rights
  - Restrictions on transfer of stock
Commonly Discussed Terms

- Information Rights
- Subordination (Debt)
- Anti-Dilution Protection
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
- 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-capsitlize
- Under-capitalize
- Ignore securities laws
- Engage a personal injury lawyer