

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

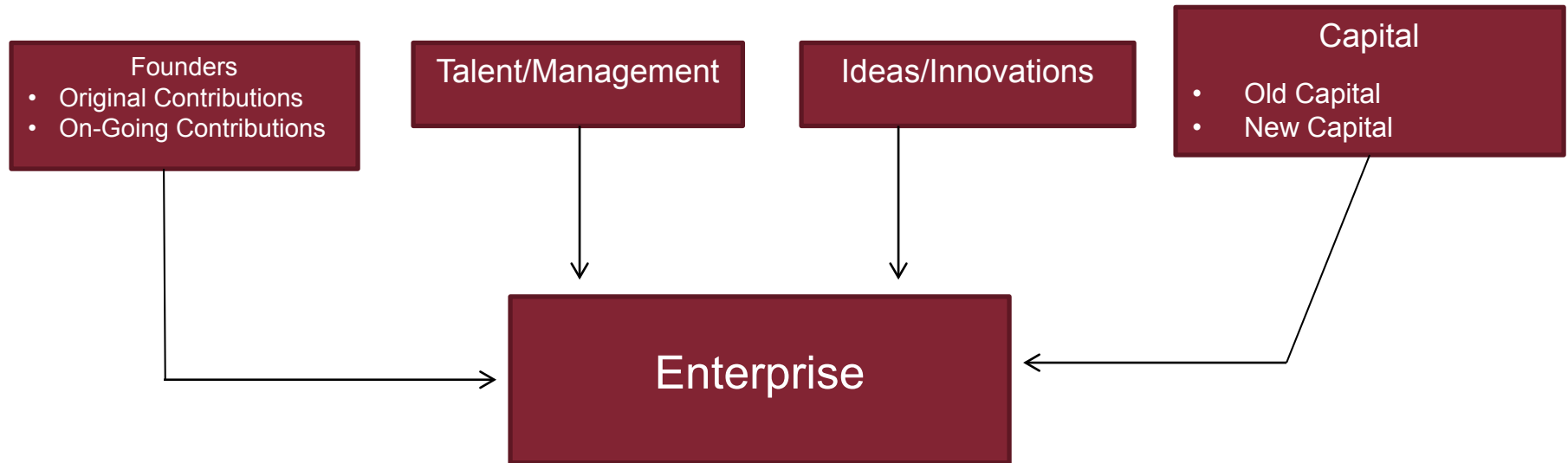
Oded Green  
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## Agenda

- Introduction
- Some Challenges and Alternatives
- 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



## **Consider Alternative Sources of Capital**

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

## Funding Cycle

- Incubators (e.g., Project Olympus, Idea Foundry, Alpha Lab, Ascender)
- 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**



## 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)



## (Relatively) New 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





## 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 – Example: NY

## 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



## 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

## Pixy (CMUcam5): a fast, easy-to-use vision sensor



Pixy is a fast vision sensor you can quickly “teach” to find objects, and it connects directly to Arduino and other controllers.

Created by

Charmed Labs and Carnegie Mellon

2,802 backers pledged \$274,352 to help bring this project to life.

Campaign

FAQ <sup>6</sup>

Updates <sup>21</sup>

Comments <sup>485</sup>

Community

## Crowdfunding – the internet exemption

- A relatively new exemption
- Regulations promulgated on October 30, 2015
- Effective Date: May 16, 2016
- Sale through registered intermediaries (brokers, portals)
- Limit on amount: **\$1,000,000 during any 12 month period**
- Significant Disclosure Requirements

## 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
  - 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
  - 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

## 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

## Convertible Debt (cont.)

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

## 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)

## 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.)

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