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

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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

Founders
- Original Contributions
- On-Going Contributions

Talent/Management

Ideas/Innovations

Capital
- Old Capital
- New Capital

Enterprise
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.
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

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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 law 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