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 (e.g., SBIR)
- 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
Accredited Investor Definition May 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
(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
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
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
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

A Better Backpack

Get a better all-day backpack designed to look amazing and carry everything, with canvas made from recycled plastic bottles

Stay Updated!

Created by Thread International

3,533 backers pledged $571,353 to help bring this project to life.
Little Sophia by Hanson Robotics

Introducing Little Sophia, Sophia the Robot's little sister, and a new kind of STEM, AI and coding learning companion for ages 7-13.

$107,921
pledged of $75,000 goal

794
backers

54
days to go

Back this project
Puzzle Clubhouse: Crowd Designed Episodic Game Dev

Ready to be a Game Designer? At Puzzle Clubhouse, people who PLAY games help MAKE games! Design, Submit, Vote and Play!

Created by
Schell Games

214 backers pledged $11,403 to help bring this project to life.
An authentic Jewish delicatessen open seven days a week, where traditional recipes are made expertly in house with great love and care.
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
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>

<table>
<thead>
<tr>
<th>Participating</th>
<th>$2M</th>
<th>$5M</th>
<th>$10M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders/Employees</td>
<td>$0M</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>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-Participating</th>
<th>$2M</th>
<th>$5M</th>
<th>$10M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders/Employees</td>
<td>$0M</td>
<td>$3.0M</td>
<td>$6.0</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>$2.0M</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%)
  - 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
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**

<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>
</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><strong>Total</strong></td>
<td><strong>1,176,471</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
**Example 1**  
Friends and Family Round  
(Priced Round)

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

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Percentage</th>
</tr>
</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>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,470,589</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
**Example 1**

**Series A Round**

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

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

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

<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>176,401</td>
<td>15%</td>
</tr>
<tr>
<td>Total</td>
<td>1,176,471</td>
<td>100%</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></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>
</tr>
</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>
</tr>
</thead>
<tbody>
<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>40%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>100%</strong></td>
</tr>
</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

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>1,000,000</td>
<td>30%</td>
</tr>
<tr>
<td>Employees</td>
<td>176,401</td>
<td>5%</td>
</tr>
<tr>
<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>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,361,145</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
## Comparison

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

| Founder           | 41%               | 46%               | 30%               |
| Employees         | 7%                | 8%                | 5%                |
| F&F               | 12%               | 6%                | 25%               |
| Series A          | 40%               | 40%               | 40%               |
| Total             | 100%              | 100%              | 100%              |
“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
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-ccapitalize
- Ignore securities laws
- Engage a personal injury lawyer