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

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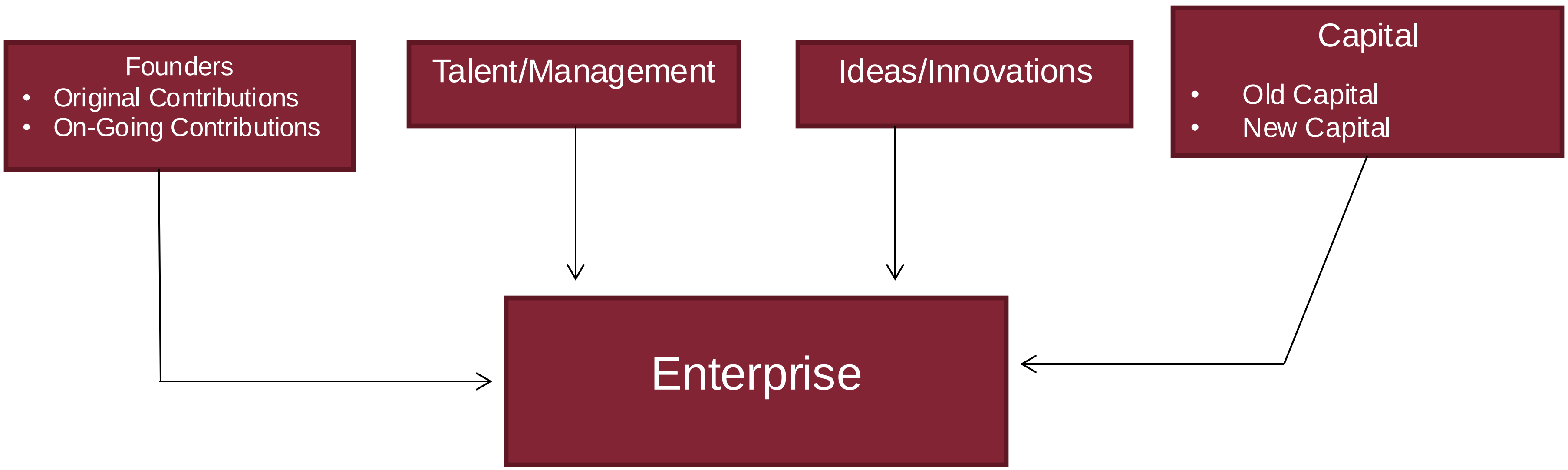
Agenda

- Introduction
- Some Challenges and Alternatives
- Applicable Laws
- The Security (debt, stock, convertible debt/SAFE)
- 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 (e.g., SBIR)
- Debt
- Crowdfunding

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Funding Cycle

- Incubators/Accelerators (e.g., Project Olympus, Idea Foundry, Alpha Lab, Ascender, LifeX)
- Public or quasi-public funds (e.g., Innovation Works)
- **Friends and Family**
- Angels
  - **Early Stage**
  - Later Stage
- Venture Capital/Strategic Investors
  - **Early Stage**
  - Later Stage
- Public Markets

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Securities Act of 1933


FRIDAY, OCTOBER 25, 1929.

Daily Mail

CONTINENTAL EDITION

GREATEST CRASH IN WALL STREET'S HISTORY

DELUGE OF PANIC SELLING OVERWHELMS MARKET

19,000,000 SHARES CHANGE HANDS

PRICES TUMBLE LIKE AN AVALANCHE

GREAT FILM FIRE AT HOLLYWOOD

NEGATIVES DESTROYED.

ATTEMPT TO KILL PRINCE HUMBERT

BETROTHAL DAY DRAMA

SHOT AT BY SOCIALIST

SEARCH FOR NEW FRENCH PREMIER

- 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 <u>not</u> 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

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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)

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

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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

Bottom Line

- Rely on 506(b) or 506(c)
- Decide between 506(b) and 506(c) early
- Don’t advertise until decision is made

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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 Disclosure

- Description of Issuer
- Business plan
- **Risk factors**
- Subscription procedures
- **Conflicts of interest**
- Financial statements
- Capitalization
- Exhibits (e.g., organizational documents)
- In general – “Material” information

Type of Security

- Debt
- Convertible Debt/SAFE
- 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

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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) (hidden dilution)
  - 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) <u>and</u> participates on a pro rata basis

- **Non-Participating Preferred:** Investor receives the <u>greater of</u> (1) investment plus accrued dividends <u>or</u> (2) proceeds on a pro rata basis

Example of Participating Preference

$2M Investment

$3M Pre-Money Valuation

Founders/Employees	60%
Venture Capital	40%

Participating

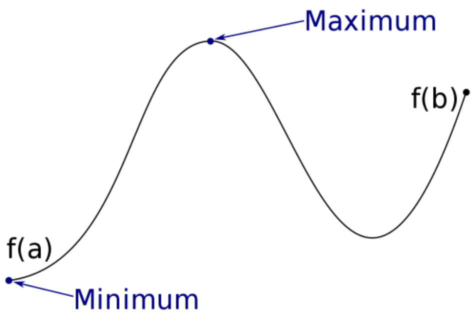
	$2M	$5M	$10M
Founders/Employees	$0M	$1.8M	$ 4.8
Venture Capital	$2M	$3.2M	$ 5.2

Non-Participating

	$2M	$5M	$10M
Founders/Employees	$0M	$3.0M	$ 6.0
Venture Capital	$2.0M	$2.0M	$ 4.0

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***



"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

Example of Cap

- $2M VC Investment
- $5M Pre-Money Valuation
- $500,000 F&F

	20% Discount	$2M Cap
Founders	60%	51%
F&F	11%	20%
VC	29%	29%
	100%	100%

Note: unintended consequence of different prices

Pre-Money v. Post-Money

- Is the SAFE/Convertible Debt in or out of the valuation/cap?
  - If included – Post-money
  - If excluded – Pre-money
- Post- Money fixes the percentage for SAFE/Convertible Debt holders
  - Investor is NOT diluted for its debt
  - Investor is NOT diluted for additional convertible debt
- Pre-Money benefits the Company
- Note: This should NOT include the priced round

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Example of Pre-Money/Post-Money

- $1M in collective SAFE's
- $5M cap

Pre-Money

Common	1,000,000	83.33%
SAFE	200,000	16.67%
Total	1,200,000	100.00%

$5M/1,000,000 = $5.00 per share

Post-Money

Common	1,000,000	80.00%
SAFE	250,000	20.00%
Total	1,250,000	100.00%

Note: $1M/$5M =20%

Convertible Debt/SAFE

- Benefits
  - Common
  - Avoids the “valuation issue” (sort of…)
  - Simpler
- Downside
  - Conversion price unknown (Risk of low valuation)
  - Usually accrues interest (can be additional dilution)
  - Debtholders 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

	Shares	Percentage Ownership
Founder	1,000,000	100%

Example 1
Employee Equity

	Shares	Percentage
Founder	1,000,000	85%
Employees	176,471	15%
Total	1,176,471	100%

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%

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Example 1
Series A Round

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

Founder	1,000,000	41%
Employees	176,471	7%
F&F	294,118	12%
VC ($2.04 per share)	979,608	40%
Total	2,450,197	100%

Note: VC will want employees' amount increased
Note Control

Example 2
Initial

	Shares	Percentage
Founder	1,000,000	85%
Employees	176,401	15%
Total	1,176,471	100%

Example 2
(Convertible Debt)

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

Founder	1,000,000	46%
Employees	176,401	8%
F&F ($1.82 per share)	136,791	6%
Series A ($2.28 per share)	875,461	40%
Total	2,188,653	100%

Comparison of Priced Round v. Convertible Debt

	Example 1 (Priced Round)	Example 2 (Convertible Debt)
Founder	41%	46%
Employees	7%	8%
F&F	12%	6%
Series A	40%	40%
Total	100%	100%

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

Founder	1,000,000	30%
Employees	176,401	5%
F&F	840,286	25%
Series A	1,344,458	40%
Total	3,361,145	100%

Comparison

	Example 1 ($250,000 Priced Round)	Example 2 ($250,000 Convertible Debt)	Example 3 ($1M Convertible Debt)
Founder	41%	46%	30%
Employees	7%	8%	5%
F&F	12%	6%	25%
Series A	40%	40%	40%
Total	100%	100%	100%

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

- Reverse-Vesting for Founders
- Founder Employment Agreements/Restrictive Covenants
- Drag-Along Rights
- Anti-Dilution Protection
- Information Rights
- Shareholder Arrangements
  - Agreement to execute a Shareholder Agreement (for note holders)

Bottom Line

- Common or Convertible Debt
- Minimize the angel funding – it is likely to be expensive money
- Minimize control of investor
- Keep it simple

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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