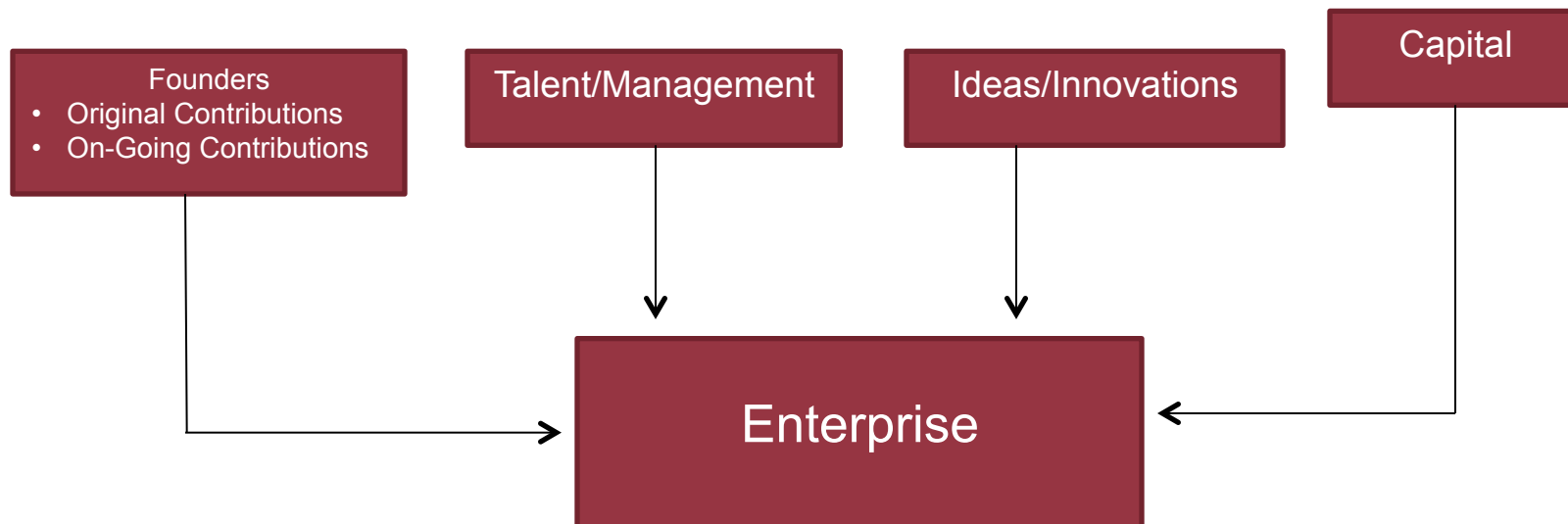


## Agenda

- 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



## 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
- Rule 506 Regulations – July, 2013
- 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

	Shares	Percentage
Founder	1,000,000	45%
Option Pool	333,333	15%
Investor	889,889	40%
<b>TOTAL</b>	<b>2,223,222</b>	<b>100%</b>

## Participating v. Non-Participating Preferred

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

## 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)

	Pre-Dividends		Post-Dividends	
	Shares	Percentage	Shares	Percentage
Founder	1,000,000	45%	1,000,000	39%
Option Pool	333,333	15%	333,333	13%
Investor	<u>889,889</u>	<u>40%</u>	<u>1,245,845</u>	<u>48%</u>
TOTAL	2,223,222	100%	2,579,178	100%



## 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

	<u>Shares</u>	<u>Percentage Ownership</u>
Founder	1,000,000	100%

## Example 1 Employee Equity

	<u>Shares</u>	<u>Percentage</u>
Founder	1,000,000	85%
Employees	<u>176,471</u>	<u>15%</u>
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 (\$0.85 per share)	<u>294,118</u>	<u>20%</u>
Total	1,470,589	100%



## 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)	<u>979,608</u>	<u>40%</u>
Total	2,450,197	100%

Note: VC will want employees' amount increased

## Example 2 Initial

	<u>Shares</u>	<u>Percentage</u>
Founder	1,000,000	85%
Employees	<u>176,401</u>	<u>15%</u>
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)	<u>875,461</u>	<u>40%</u>
Total	2,188,653	100%

## Comparison of Priced Round v. Convertible Debt

	Example 1 <u>(Priced Round)</u>	Example 2 <u>(Convertible Debt)</u>
Founder	41%	46%
Employees	7%	8%
F&F	12%	6%
Series A	<u>40%</u>	<u>40%</u>
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	<u>1,344,458</u>	<u>40%</u>
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	<u>40%</u>	<u>40%</u>	<u>40%</u>
Total	100%	100%	100%

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