

Issues Influencing Finance Structure and Investment Decisions: A Case Study

Stephen P. Charbonnet
Soffer Charbonnet Law Group, PLLC
Minneapolis

Bradley H. Lehrman
Lommen Abdo Cole King & Stageberg, PA
Minneapolis

Table of Contents

Issues Influencing Finance Structure and Investment Decisions (A Case Study)

A.	<u>ESTABLISH THE COMPANY</u>	1
1.	Entity Formation.....	1
2.	Initial Funding	2
B.	<u>BUILD AND FUND THE PROTOTYPE</u>	4
1.	Funding from “Sophisticated” Sources.....	4
2.	Advantages of “Angel” Investors.....	5
C.	<u>BETA AND STAFFING UP</u>	5
1.	Funding from “Professional” Sources	5
2.	Most private equity investments will look to Regulation D as the securities exemption although there are a variety of other exemptions that may be available depending on the specific nature of the transaction in question	7
3.	In order to obtain the safe harbor of Regulation D, offerings must comply with one of three exemptions.....	7
4.	When disclosure is required in a Regulation D offering varies depending on which rule the securities are being sold under and the status of the purchasers.....	8
5.	The nature of the disclosure required in a Regulation D offering varies depending on the issuer’s status as a public or private company and the dollar amount of the offering	8
6.	Limitations on Resale.....	8
7.	Integration and General Solicitation	8
8.	Investor Qualifications.....	9
9.	Regulation D Filings.....	9
10.	Regulation D – Proposed Revisions	9
D.	<u>BUILD PRODUCT AND LAUNCH</u>	10
1.	Company will want to compensate and incentivize management and employees.....	10
	Attachment 1 – Private Investment Transaction Document Checklist	13
	Attachment 2 – Form of Convertible Promissory Note Term Sheet.....	15
	Attachment 3 – Form of Convertible Promissory Note	16
	Attachment 4 – Recent Selected Private Equity Financing Related Articles	27
	Attachment 5 – Networking Groups List (Handout)	28

Issues Influencing Finance Structure and Investment Decisions
(A Case Study)

❖ **Background Facts:**

- Startup company planning to develop proprietary software able to more seamlessly translate web browser pages into handheld mobile browser pages
- Tom Trendsetter, Founder
 - Serial entrepreneur (3d startup)
 - Previously CEO of a public company
 - Currently planning to self-fund initial research & development but interested in discussing and considering options for raising capital

❖ **General Phases of Company Funding:**

- A. Establish the Company – Entity formation and initial funding
- B. Build and Fund the Prototype – Appropriate types and sources of funding
- C. Beta and Staffing Up – How much money to raise and how to raise it
- D. Build Product and Launch – Compensate and incentivize management and employees

A. **ESTABLISH THE COMPANY**

1. **Entity Formation**

a. **Corporate Form**

- i. **C Corporation**
- ii. **S Corporation**
- iii. **Limited Liability Company**

b. **Tax considerations**

- i. **Pass through losses depending on entity choice**
- ii. **Tax issues for investors**

❖ **Business Considerations:**

- Attorney not just a scrivener; part of management/advisory team
- Business decisions have legal implications now & later
- Overall consideration of how to build a business base and get funded

❖ **Legal Considerations:**

- Similar corporate protection for corporation or limited liability company

- Less corporate formality with an LLC
- Investor friendly entity structure may require conversion of entity later
- Liquidity/illiquidity issues

2. Initial Funding

a. Debt v. Equity

i. Pros & Cons of Debt Financing

1. Advantages to Small Business/Founder(s)

- a. Simple (usually, but banks can be more difficult)**
- b. Nondilutive**

2. Disadvantages to Small Business/Founder(s)

- a. Debt service (cash flow is extremely important and usually very tight)**
- b. Limitations on leverage**
 - i. Lenders will consider debt ratios for future lending**
 - ii. Too much debt may hurt ability to raise equity later**
 - iii. Personal Guaranty likely required from founder(s) by a bank**

3. Advantages to Lender

- a. Senior position to equity holders in a dissolution**
- b. Debt repayment with interest is a source of revenue**

4. Disadvantages to Lender

- a. Unsecured debt is risky; additional steps necessary to secure debt**
- b. Participation in company's growth is limited to debt repayment**
- c. Intellectual property as collateral can be of little value to a bank**

ii. Pros & Cons of Equity Financing

1. Advantages to Small Business/Founder(s)

- a. Investors bear risk of loss of investment**
- b. Immediate capital infusion**
- c. Theoretically unlimited ability to raise money by selling equity interests**
- d. No debt service**

2. Disadvantages to Small Business/Founder(s)

- a. Stock sales can be complex and expensive business transactions (costs \$ to raise \$)**

- b. Highly regulated by state and federal laws
 - c. Dilutive event for existing stockholders
- 3. Advantages to Investor
 - a. Higher risk may yield higher return on investment than debt
 - b. Participation in company's financial success
- 4. Disadvantages to Investor
 - a. Junior position to creditors in a dissolution
 - b. Illiquid investment – need a liquidation event to “cash out” and realize value (ex. merger, acquisition, IPO, liquidation)
- b. Self funding v. outside funding (friends & family)
 - i. Sources of Debt Financing
 - 1. Traditional Private Lenders – banks, credit unions, credit cards
 - 2. Traditional Public Lenders – government loan programs (SBA)
 - 3. Other Private Lenders – “angel” investors, friends & family
 - ii. Sources of Equity Financing
 - 1. Personal savings
 - 2. Friends & family
 - iii. Advantages of friends & family
 - 1. Personally and professionally supportive
 - 2. Tends to be easy, informal process
 - 3. Flexible terms and conditions
 - iv. Disadvantages of friends & family
 - 1. Typically not sophisticated investors; be sure they understand the investment risk
 - 2. Bad deal can affect personal relationships
 - 3. Informality can mean problems later (expectations, documents, disclosure)

❖ Business Considerations:

- Needs to be “fund-worthy”
- How “bankable” is/are the founder(s); personal guaranty likely required for loans
- Business plan should address financing issues
- Like a chess match; attorney helps analyze steps now to end up with fewer mistakes later
- Consider use of Nondisclosure Agreement under appropriate circumstances

- ❖ Legal Considerations:
 - Applicability of the securities laws
 - Triggered by the purchase or sale of a “security,” the definition of which is very broad
 - Generally, a securities transaction occurs if a person invests in an enterprise and expects profits from the managerial efforts of others or if a person provides the risk capital for an enterprise and expects profits without receiving the right to exercise practical and actual control over managerial decisions
 - Determining Whether an Investment Constitutes a Security May be Difficult
 - Stocks and bonds are traditional forms of “securities”
 - Other types of investments may be securities depending facts
 - The typical bank loan with a promissory note will generally not trigger the securities laws
 - Convertible promissory notes from the company to investors are securities
 - Section 4(2) exemption for “transactions by an issuer not involving any public offering”
 - Minnesota Statutes Chapter 80A sets forth applicable state statutes regarding registration of securities

B. BUILD AND FUND THE PROTOTYPE

1. Funding from “Sophisticated” Sources

- a. Type of Investor(s) depends on stage of company’s development
 - i. “Angel” Investors
 - ii. Small/Local Fund Networks

- ❖ Business Considerations:
 - Networks can be difficult to find and even more difficult to access
 - Lawyer can be very helpful in finding “Angels”
 - Angels often invest in the \$100-\$1MM range (can be higher or lower)
 - Networking Groups List handout is a good starting point
- ❖ Legal Considerations:
 - Recommend dealing only with “accredited” investors
 - Need to determine applicable exemption
 - Need appropriate disclosures for types of investors
 - Be careful of the types of rights granted to investors at this point; could create issues later
 - Board seat
 - Antidilution
 - Preferred stock rights

2. Advantages of “Angel” Investors

- i. Typically sophisticated investors**
- ii. Tend to be less active than other “professional” investors in management matters**
- iii. Flexible terms and conditions**
- iv. Industry contacts can be especially helpful in later rounds**

b. Disadvantages of “Angel” Investors

- i. Can be difficult to find/meet (need connections, interest in your space)**
- ii. Unregulated party (ex., terms of deal can be aggressive)**
- iii. Security for repayment of company debt may be required**
 - 1. Personal guarantee**
 - 2. Pledge of shares**

❖ Business Considerations:

- Valuation issues typically arise at this point
- Debt has certain advantages over equity at this point
- Company may consider a private placement/offering of stock
- Later investors may consider earlier rounds in determining valuation
- Diligence issues may cause investors to seek to mitigate risk by valuing company at a discount

❖ Legal Considerations:

- Selling common stock is a securities issuance (even to friends & family)
- Legal counsel should be involved throughout the offering and sale process
 - assist in preparation of private placement memorandum and/or other disclosure documents
 - be involved in planning before offering, during sale and after; involvement only after can be too late
 - Pay attention to state(s) in which investors live (state blue sky law issues)
- Legal documents need to be accurate and complete so that later investors doing due diligence don't find problems

C. BETA AND STAFFING UP

1. Funding from “Professional” Sources

- a. At this stage of company's development, likely raising larger dollar amounts from deeper pockets**
 - i. Venture Capital**
 - ii. Institutional investors**
 - iii. Strategic partners**
- b. This is probably the valuation that will “matter”**
 - i. Early valuations may have been too high/too low (usually too high)**

ii. Depending on how earlier investments were valued and structured, existing shareholders could get “squeezed” down

❖ **Business Considerations:**

- Company’s goal at this point is to capture users and monetize their product
- Lawyer can be very helpful to company in evaluating which potential investment is the best deal – NOT based solely on dollar amount proposed to be invested
- Lawyer should be engaged to assist in negotiating terms; potentially very complex documents with broad implications for the company and other shareholders

❖ **Legal Considerations:**

- Get involved at the beginning of the process; client discussion should include
 - how much the client is going to offer/sell
 - ◆ existing capital structure
 - ◆ rights of first refusal
 - ◆ enough authorized capital stock
 - when and what the client last sold
 - ◆ same security or not
 - ◆ how long between offerings
 - where the client intends to sell
 - ◆ blue sky law requirements unique to each state
 - ◆ securities legends in ppm
 - how the client intends to go about offering/selling
 - ◆ finders
 - ◆ broker/dealer
 - to whom the client will be offering/selling
 - ◆ accredited investors
 - ◆ non-accredited investors
- Need to determine applicable exemption
- Need to establish basis for exemption
 - Subscription Agreement reps and warranties
- Need appropriate disclosures for types of investors
 - ◆ accredited investors
 - ◆ non-accredited investors
- Need thorough and accurate documentation of the transaction
- Company will need to go through an investment due diligence process with one or more potential investors for each round of financing
- Help the client understand ways to avoid a general solicitation (ex. No talking to the press)

2. Most private equity investments will look to Regulation D as the securities exemption although there are a variety of other exemptions that may be available depending on the specific nature of the transaction in question
 - a. Absent an exemption from registration, every securities transaction that uses the U.S. mails or other means of interstate commerce must be registered with the Securities and Exchange Commission (the "SEC").
 - b. Section 4(2) of the Securities Act of 1933, as amended (the "Act") exempts from the registration requirements of Section 5 all "transactions by an issuer not involving any public offering."
 - c. The interpretation of Section 4(2) by the SEC and the courts was not always crystal clear, so in 1982 Regulation D was adopted by the SEC as a regulatory safe harbor.
 - d. Offerings that are in compliance with the requirements of Regulation D will not be considered public offerings and will not, therefore, require registration.
 - e. Regulation D was "designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors." *Securities Act Release No. 33-6389 (March 8, 1982)*.
 - f. Regulation D applies only to issuers, individuals may not use Regulation D.

3. In order to obtain the safe harbor of Regulation D, offerings must comply with one of three exemptions:
 - a. **Rule 504:** Offers and sales not exceeding an aggregate offering price of \$1,000,000 during any 12-month period
 - b. **Rule 505:** Offers and sales to an unlimited number of accredited investors and a maximum of 35 non-accredited investors where the offering price does not exceed \$5,000,000 during any 12-month period
 - c. **Rule 506:** Offers and sales to an unlimited number of accredited investors and up to 35 non-accredited investors, who must be sophisticated investors, without regard to the dollar amount
 - i. Securities issued under 506 are "federal covered securities" therefore state registration and qualification requirements are preempted by Section 18(b)(3) of the Act
 - ii. If issuer loses 506 exemption can potentially fall back on 4(2), not so with others
 - iii. "Sophisticated" investor means that the purchaser or purchaser's advisor must have such knowledge and experience in financial matters that he or she is capable of evaluating the merits and risks of the particular investment

4. When disclosure is required in a Regulation D offering varies depending on which rule the securities are being sold under and the status of the purchasers
 - a. A written disclosure document is required when securities are sold under Rules 505 or 506 to anyone that is not an accredited investor
 - b. When securities are sold under Rule 504 or only to accredited investors, there is no mandatory disclosure but the antifraud and civil liability provisions of the federal securities laws still apply as well as any state securities laws that may be applicable

5. The nature of the disclosure required in a Regulation D offering varies depending on the issuer's status as a public or private company and the dollar amount of the offering
 - a. All issuers making offerings under Rules 505 and 506 must allow investors the opportunity to ask questions and obtain additional information that the issuer can acquire without unreasonable expense or effort and advise non-accredited investors of the limitations on resale
 - b. Public companies may use information on file with the SEC (10-Q, 10-K, proxy, etc.)
 - c. Private companies must provide disclosure based upon the dollar amount of the offering
 - i. Regulation A for offerings up to \$2,000,000
 - ii. 1933 Act registration forms for offerings exceeding \$2,000,000
 - d. Higher disclosure obligation with non-accredited investors

6. Limitations on Resale
 - a. Most securities issued under Rules 505 and 506 are "restricted securities" meaning they have been acquired directly or indirectly from an issuer, or from an affiliate of the issuer, in a transaction or series of transactions which do not involve a public offering and are subject to resale limitations
 - b. Issuers relying on a Regulation D exemption must take reasonable care to ensure that the purchasers are not "underwriters" as defined in Section 2(11) of the Act.
 - c. Issuers evidence their "reasonable care" through the written disclosures and legends on share certificates regarding resale limitations and the investor representations at the time of sale
 - d. Securities sold under a Rule 504 offering that is registered with the state may be resold freely

7. Integration and General Solicitation
 - a. Rule 502 provides a safe harbor from integration for offerings completed six months before or commenced six months after other offerings of securities of the same class
 - b. Two or more offerings that might qualify separately as exempt may be deemed to be a single offering if they occur too close together

- c. A five factor test is used to determine whether integration will occur
 - i. Part of a single plan of financing
 - ii. Same class of securities
 - iii. Offered at or about the same time
 - iv. Same type of consideration paid
 - v. Same general purpose
- d. The use of general solicitation or general advertising for a Rule 505 or 506 offering is prohibited
- e. General solicitation and advertising are permitted only for certain types of Rule 504 offerings with state registration or applicable state exemptions

8. Investor Qualifications

- a. To be an “accredited investor” the purchaser must fit into 1 of 8 categories listed in Rule 501(a)
- b. Individual “accredited investor” is defined as any director, executive officer or general partner of the issuer; or \$1,000,000 net worth (can include spouse); or \$200,000 individual/\$300,000 joint annual income for past 2 years
- c. Accredited investors are not counted in calculating the number of purchasers under Reg. D
- d. Note that this is different from the Rule 506 “sophisticated” investor concept although the terms are often used interchangeably

9. Regulation D Filings

- a. File Form D with the SEC and applicable state securities agencies
- b. File within 15 days after the first sale in the offering (Rule 503)
- c. Insignificant deviations won't cause loss of exemption (Rule 508)

10. Regulation D – Proposed Revisions

- a. *Securities Act Release No. 33-8828 (August 3, 2007)*
- b. Intended to modernize and clarify Reg. D in light of today's market, economy and technology
- c. New proposed Rule 507
 - i. New “large accredited investors” category
 - ii. Limited advertising to “large accredited investors”
 - iii. No sales to non-accredited investors under Rule 507
 - iv. Exemption based on SEC's general exemptive authority under Section 28 rather than Section 4(2)
- d. Additional changes to Section 501(a) definition of “accredited investor”
 - i. Alternative “investments owned” standard to the current asset and income standards
 - ii. New mechanism for adjusting dollar thresholds for inflation
 - iii. Several new categories added to list
- e. Changes to the General Conditions
 - i. Shorten safe harbor from 6 months to 90 days

- ii. Revised disqualification provisions under Rule 502(e)
- f. **Electronic filing of Form D and revisions and updates to information requirements**

D. BUILD PRODUCT AND LAUNCH

- 1. **Company will want to compensate and incentivize management and employees**
 - a. **Stock Options**
 - i. **Options are securities**
 - ii. **Document options properly**
 - 1. **Option plan (as applicable)**
 - 2. **Stock Option Agreements for each optionee**
 - b. **Rule 701 -- Exemption for Offers and Sales of Securities Pursuant to Certain Compensatory Benefit Plans and Contracts Relating to Compensation**
 - i. **Issuers eligible to use this section of the '33 Act (federal exemption) if not a reporting company**
 - ii. **Pay attention to requirements relating to state exemptions as well**
 - 1. **Rule 701 is not an exemption from applicable state securities laws**
 - 2. **Minnesota Statutes Section 80A.46 sets forth applicable state transactional exemptions**

❖ **Business Considerations:**

- **Size of option pool likely a negotiated point with venture capital/institutional investors**
 - **Make sure investors are in alignment with size of option pool**
- **Management will need to determine terms of options and get necessary approvals**
- **Options give management and employees participation in potential success/upside of business**
 - **Use to judiciously compensate management, employees and board**
- **Goals at this stage**
 - **develop and build the company**
 - **hit the market aggressively**
 - **build management team**

❖ **Legal Considerations:**

- **Must pay attention to satisfying requirements of Rule 701**
- **State exemption requirements may impose an additional burden, make sure to check applicable blue sky laws**
- **Need to make sure the company/management is very diligent about documenting options grant process**

- Number and grant date of Options
- Vesting Schedule
- Strike Price
- Document approval of grant
- Signed documents

ATTACHMENTS

Attachment 1 – Private Investment Transaction Document Checklist

Attachment 2 – Form of Convertible Promissory Note Term Sheet

Attachment 3 – Form of Convertible Promissory Note

Attachment 4 – Recent Selected Private Equity Financing Related Articles

Attachment 5 – Networking Groups List (Handout)

ATTACHMENT 5
NETWORKING GROUPS LIST (HANDOUT)

- Angel Capital Assoc. www.angelcapitalassociation.org
- Angel Healthcare Investors www.hcangels.com
- The Collaborative www.collaborative.net
- Get Go Minnesota www.getgomn.org
- Lifescience Alley www.lifesciencealley.org
- Minnesota Business Plan Competition (Minnesota Cup)
www.breakthroughideas.org
- Minnesota Venture Capital Association (MVCA) www.mnvca.org
- National Venture Capital Association (NVCA) www.nvca.org
- Twin Cities Angels www.tcangels.com