

Legal Issues for Entrepreneurs, Start-Ups and Emerging Companies
Which Are
Preparing to Raise Capital From Investors

Presentation by Nancy Fallon-Houle 2006 ©

Corporate Law Points & Business-Building Points

Key issues for start-up or early stage companies:

• **Who owns IP?**

- **Developed** Where? While employed somewhere else? Might they have a claim to it?
- **Co-developed** with another party? If so, legal rights assigned to you? If not, it's not yours to develop.
- **Protection of Intellectual Property**
 - Is protection of your IP Possible? Patented? Business Process Patent option? Have you blown that protection by putting your ideas in the public domain
 - NDAs for Employees and Partners
 - Name and trademark (see 2nd from next item)
 - Balance how much to disclose in O. Memo vs. Proprietary Info
- **All info about the intellectual property, and who owns it must be in the disclosure document / offering memo**

• **Noncompete with current or former Employer**

- Does your current, or former, employer's Non-Compete Agreement or Employment Agreement **impede your starting your business?** To what degree? Applicable after you leave? How Long?
- Employer **perhaps may negotiable on a supplement** to the agreement that would allow you to start your business, compete in their space,
 - But not steal their customers, or employees?

• **Name Check:** Critical **before business formation** or growth, importance of global name check, given the global use (and surveillance) of business names through Internet.

[Hand out – Incorporation / LLC Formation Checklist, including search vehicles & techniques for “knock out” name search]

[Hand out - Filing Fees For Business Formation]

[Hand out - Corporate Maintenance Checklist – “Legal Ducks in a Row”]

All info about rights to name and logs must be in the offering memo

• **Corporate Formalities –**

- **Keep corporate records straight, especially stock records.**
 - **Stock ledger is you corporate check book for you company's bank account of shares**
 - **Botched Do-It-Yourself Incorporation**

- **Separate finances, actions, contracts:**
 - **From personal and**
 - **From other businesses**
- **Diligent accounting records**
- **Follow Corporate Formalities**
- Investor due diligence on these
- *All material info about the Company must be in the offering memo or disclosure document*

- **Use Technology to Operate Your Business – or you’ll be left in the dust**

- **Business Ducks in a Row –**

- **Research and Know your industry,**
 - **No such thing as “no competitors”, what are the current substitutes**
- **Daily Internet searches to keep your info current**
- **Suppliers in place, as close to letter of intent or contract as possible.**
- **Customers in place, if appropriate or possible, even one or two customers**
- **Industry Compliance – hire experts , such as Telco**
- **Due Diligence on Company you Keep – business reputation sometimes affected by those you partner with**
- *All material info about the business and industry must be in the offering memo, describe industry, market place, competitors, other players who are not direct competitors, risk factors.*

[Hand out – Article “Is Your Business Investor Ready”? and [“20 Questions VCs Will Ask”] and “Due Diligence Questionnaire”?]

- **Business Contracts: Use them.**

- **Oral Relationships** - Investors will **not invest on deal built on them**, not matter how solid. Make the deal, but eventually paper it
- Expensive to paper all agreements at once and retroactively.
- Shareholder agreement between you and **your business partners –founding partners, alliance partners** [Hand out available by email, Checklist of discussion items among partners in corp]
- *Must summarize all material contracts in the Disclosure Document / Offering Memo.* Have to have the deal papered in order for securities lawyer to summarize it.

- **Due Diligence - Clean Background is Key**
 - **Due Diligence that Investors will conduct on Principals**
 - **Background checks**, criminal, regulatory, tax liens, bankruptcy
 - Principals (D's & O's, Control Shareholders), the entity itself, and prior business and legal history) – All of above, plus business reputation
 - *All material info about the principals must be in the offering memo*
- [Hand out – Due Diligence Questionnaire for Private Placements]

Built the foundation, have business plan, now ready to prepare to raise capital

Raising Equity Capital

The capital raising process for small businesses is comprised of a series of cash infusion events in several stages.

- No such thing as 12 months to IPO, and it's a myth that a company can "go public" on its first capital raise, or even within 5 years of start-up. Generally 5 to 10 years to IPO, generally companies with 300+ employees and \$1 million in net income.
- Normal route is that a company is funded in the many stages:
 - Seed capital from founders' personal savings & credit cards
 - Family & close friends
 - Angels / friends/ business associates
 - VC round
 - More VC rounds
 - Then "liquidity" event:
 - Continued self-funding by the businesses revenue
 - Acquisition
 - Merger
 - IPO, or
 - Management buy-out of investors.

Equity advantages over Debt:

- If equity deal crashes, you are **not personally liable** (However, you **are personally** liable in equity raise, if you have in any way, misled investors or misstated any fact, or even a shade of meaning in the disclosure, and they sue you in a securities fraud lawsuit)
- Equity Broadens the company's horizons because decisions will now be made by "committee" of investors and larger board, rather than narrower decision factors determined by bank loan officer and you and your small, closely held board.
- Access to capital not based on loan-to-value, or personal collateral available for security, especially attractive for early stage companies who don't qualify for equity.
- Investors share fully in your losses (and profits!)

- **Realistic Expectations as to Cost, Timing, Involvement –**
 - **Months** not weeks
 - Cash from your pocket – Money where your mouth is
 - Not free or cheap, no payments out of proceeds
 - **Operational Documents Needed:** [NFH] Founders Agreement; Offering Memo; Shareholder Agreement; Subscription Agreement. No detail required here.
 - **Full time job while its in process**

Securities Sales and Laws

- **Issuing any equity interest in your company, in exchange for cash, property, or services, or a vendor/supplier contract, is a securities issuance. Even selling stock to your mother is a securities sale.**
 - **Any share of stock, LLC interest, or LP interest,**
 - An “investor” is any person who gives you money, property, or free services, in exchange for equity, with intention of making return or profit on their investment in your company. Such a transaction is the issuance of a security.
- Even issuing, *or giving*, **equity interests to employees**, board members, advisors, or consultants, in exchange for services, is a securities issuance.
 - A “Securities” issuance includes shares, options, warrants, any employee plan interest, (employees and advisers), even for services and no cash
- **If we have the issuance of a security, then registration or exemption required.**
- **Key to find exemptions from registration.**
- **However, there are no exemptions from disclosure – the “Offering Memo”**
 - **Exemptions are from registration, and not from disclosure or notice filings.**
 - **Disclosure is the SOLE requirement of the 4(2) and Reg D exemptions in most cases, if all investors are accredited.**
 - **Disclosure is the CYA, the insulation against a lawsuit if deal crashes.**
- Even **disclosure can be curtailed**, but not omitted, in a few instances of
 - **Seed capital, first small money in after founder’s money**, and
 - Only in cases where all investors would **never** sue you even if you lost all of their money (I call it the “folks who would never sue you exemption”)
 - Very limited in number, like 1 to 3 investors
 - Immediate family (parents siblings), small number, providing start-up seed money (perhaps up to 5 immediate family members)
 - “Single, Sophisticated” investor providing single shot of start up seed money, someone well-known to the company and principals.
 - Other very limited situations by judgment of the attorney after discussion with attorney about the facts of the investors

- Even without a traditional disclosure document, you still need to provide disclosure some how, and comply with the requirements. **Don't do this at home without professional advice and help**
- Land mine of errors that, in the worst case:
 - Have to give back the money (rescission), and/or
 - Can forever bar you from raising additional money
- Other methods of accomplishing disclosure under 10b-5: Providing everything investors need, or ask for, all material information, in the form of a “document stack and financials”. Include full disclosure of all due diligence info.
- 4(2) – exemption, very small group
- **Exempt from complex disclosure, but investors often require complex terms and investment documents before they will invest**
- **Or Use the safe harbor of a Reg D 506 with Offering Memo**

Disclosure Document / Offering Memo

• **The “CYA” Document**

[Hand out – Why Offering Memo Required]

- Securities law rules require Disclosure of all info material to investment decision
- Not promising to make money, not promising a fair deal, just telling facts of people, industry, strategy
- If you are uncomfortable disclosing it, its probably material
- Protect, not insulate, from liability
- Cost: Is a \$25,000 insurance policy
- Initial Cost is high, but the first private placement memo can be recycled and enhanced with each successive deal, more complex deal, and even act at the foundation for the IPO prospectus.
- Saves you time as a business tool, so that you are covering much of your presentation first in writing
- No need to repeat same info to multiple parties over and over.
- CYA so that you are saying the same thing to each investor – no deviation

[Hand out – Why Offering Memo Required]

- **Disclosure Doc Highlights Bios, U of P, Cap table, Industry Analysis, Risks**, Corporate and Personal Due Diligence, Summary of all material agreements.

Notice Filings Required for EVERY deal and Every Sale to Investor

- **Notice filing required with the SEC - SEC Form D if Reg D**
- **Blue Sky Law - Notice filings are required in each state in which investors reside;**
 - Whether it's a Reg D or not
 - For sales or issuances to family, friends, employees, angels, VCs and sometimes institutions.
- **Filings required in almost every state**

- Tell company counsel & securities lawyer immediately when investor checks come in, because filings are required within 15 days after sale.
[Hand out summarizing 50-state notice filing requirements.]
- **Securities Law Issues for Private Offerings**
 - **Private vs. Public**
 - **Why It's Illegal to Offer Your Fund on the Internet**
 - **Limitations on Solicitations**
 - **Manner of Offering – No general Solicitation**
 - Private vs. Public Fund – Don't want to be a public fund
 - Illegal to Offer Your Fund on the Internet,
 - IPO.Net and Lamp Technologies apply to brokered funds only
 - Cold Calls, Advertising prohibited
 - Pre-existing relationship or private introduction
 - Cold calls to Professional VCs are probably OK, but gray area
 - **What Is an SEC Reg D 506 Offering?**
 - **Compare to 4(2)**
 - **Why Reg D 506 most preferable** Why Reg D 506 most preferable – Blue Sky – But disclosure required
 - **Limits on # of investors 35**
[Handout – Private Offering Exemption Q & A Chart]
 - **Investor Qualifications - What is an Accredited Investor?**
 - **Why prohibit, or limit, sales to them** sophistication
 - **Audited Financials requirement for nonaccrediteds**
 - **What about family who are not accredited?**
 - **Risk of non-compliance is rescission (give back the money)**
- **Selling the deal –**
 - **Full disclosure**, whole truth and nothing but the truth.
 - **No superlatives.**
 - **No BS**
 - **Separate selling your product** and the virtues of your company from selling the stock in the company, Turn off the marketing press.
 - You're **not selling real estate or a used car** – “if you don't buy into the opportunity today, it will be gone” is not appropriate
 - Will be **partners with your investors** for a long time, and want to develop and maintain a good relationship with them, don't BS them.
 - **Lawsuits for misstatements or even misleading statements**
- **Using Money finders to sell your stock:**

- **Illegal if they are not registered** securities brokers under 1934 Act. Ask for their CRD number and run it through www.nasdr.com.
- **Be careful**, as the finder pool contains a high percentage of **disbarred** stock brokers and lawyers, de-licensed insurance brokers and real estate brokers, and convicted felons.
- **Check references** and experience level
- Make sure they have **good book of investor** business
- Red Flag if they are advertising in the paper or on Internet “money available”.

Handout “Deal Structure and Term considerations”

Common Mistakes:

- Salaries to Founders , or paying back founder loans, early in the game
- Pie-in-the-sky projections, or
 - only one set of projections or
 - no back up for the projections
 - excel sheet that does not add up
- Using AOL or hot mail or as your business email account,
 - looks unprofessional and
 - emails of any size will bounce,
 - can’t store emails to keep as business records
 - Spend on technology
- Unrealistic expectations about % of equity give-up for the funding you so desperately need.
- Ignoring Due Diligence Issues in backgrounds of principals, officers and directors
- Dispensing stock loosely, to everyone including the cleaning lady
- Waiting too long to start preparation for a capital raise, creating an emergency out of it.
 - Desperate will be written all over your face and your financials
 - Intention is to overlap between the next capital raise and the end of the current money.
 - Allow 12 to 18 months to do the preparation, find the money and close the deal.
- Wrong Motivation for doing capital raise – to Cash you out
 - Examine your motivation
 - Not a get rich quick scheme based on exit quick strategy – long haul
- Believing that your lawyer or accountant will find your investors for you
 - Definition of private placement

- Believing that your lawyer, accountant and other professionals can be paid out of proceeds of offering
- Thinking that a Business plan is an offering memo;
- Not realizing that Sophisticated Investors will negotiate terms, you can raise a lot from them, but they will hold you hostage to their terms. Friends and family will not negotiate terms, but you can't raise much from them.