

FINANCING A STARTUP

PART 2: LEGAL ISSUES

PEPPERDINE LAW SCHOOL
ENTREPRENEURSHIP PRACTICUM

1Q17

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Please note that this presentation does not constitute legal advice.



STARTUP LEGAL OVERVIEW: TOPICS

1. Interaction of Various Areas of the Law
2. Due Diligence: What It Is & Why It Matters
3. Basic Elements of the Deal
4. The (Non) Issue of Valuation
5. Core Deal Documents



PART 1. INTERACTION IN THE LAW

1.1 Corporate Structure:

- *What Can Go Wrong/What Needs to Be Correct*

1.2 Intellectual Property:

- Who Owns What & How Do You Know?

1.3 Labor & Employment Law

1.4 Transactional (corporate/commercial)



1.1 CORPORATE ISSUES TOC

- Problems with the sole incorporator*
- Problems with the Articles/Certificate
- Stock Issuance
 - e.g., restricted stock legends
 - Stock ledger



CORPORATE ISSUES

How are the first directors elected?*

- Sole incorporator must sign the document
- Who elects the officers?
- Who makes business decisions?

Articles insufficient shares or classes

- Articles authorize 1,000,000 shares of common stock: Company issues 2m
- Similar problem with second class of stock
 - Can an S corp issue a second class of stock?*



CORPORATE ISSUES (CONT'D)

Authorized v. Issued?

- Difference
- Best number for issuance?
- How do you change issuance limits?



P.153 OF READING

RESOLVED, that the Corporation accept the offer of Ian Gorton and of Betty Paul for each to purchase 5% of the Corporation's common stock, each such percentage of shares in exchange for \$5,000 cash plus consideration as set forth in the Assignment Agreement [. . .].

- What are the problems with using percentage (rather than a number of shares)—both now and in the future?



SWEAT EQUITY MISTAKE

Founder to potential CTO:

“I’ll give you 5% of the stock if you join us.”

Problems:

- 5% of what? Outstanding today, next financing round, forever?
- When is it given: today? Vesting period? If she leaves?

(A)(1)



1.2 IP ISSUES TOC

The Pizza Box Dilemma

The Developer Dilemma

The University Grant Dilemma



IS A PIZZA BOX A "TANGIBLE MEDIUM?"



While we are eating and talking I write the code on the pizza box. Who owns that code?*

(Trento)



THE DEVELOPER SENDS YOU CODE

Who owns what she creates?

- Written assignment?
- Can she re-use it?
- Has she re-used code from her other clients?

What tools did she use to create it?

- Are there GPL/GNU obligations?

Who will own subsequent developments?



UNIVERSITY LARGESSE

Your core molecule (or code) comes from a university project funded by the university.*

- Your co-founder brought it with her.
- She doesn't sign anything.

Open Source licenses. Patent “Left” or DPL



STANFORD V. ROCHE

IP requires a written instrument to assign rights.

- Pure legal formalism?
 - *I agree to assign my IP rights to you*
 - *I hereby assign [. . .]*
 - Subject to your compliance with the payment terms of this Agreement, I *hereby grant [. . .]*.



1.3 LABOR & EMPLOYMENT

You have your independent contractor sign an IC agreement, with work-for-hire language. (She lives in Maine.)

– Can you be liable for a penalty and criminal prosecution?

- California Labor Code 3351.5(c)
- California Unemployment insurance Code Section 621(d) and 686

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1.4 CORPORATE/TRANSACTIONAL ISSUES

Your startup has an agreement with a major B2B client with an assignment clause.

- Can you issue equity that will result in a change in control?
- Can your company be acquired?
- If you represent the client, can you draft a way to prevent that acquisition?
- Can that client prevent you from being acquired by one of its competitors?*



PART 2: DUE DILIGENCE: WHAT IT IS & WHY IT MATTERS

- 2.1 Goals
- 2.2 Due Diligence Components
- 2.3 Consequences & Solutions



2.1 DUE DILIGENCE GOALS

- What are we buying?
- Is it what the sellers say it is?
- What are the liabilities?
- How do we resolve it/What are the consequences?

Start with the likeliest and the most important



DUE DILIGENCE: THE BOTTOM LINE

- Does the corporation “exist” in legal terms?
 - Creature of the state (Delaware) & corporate formalities
- Do the corporate documents indicate that the corporation “acted” in a legal manner?
 - Corporate minutes
 - Bylaws
 - Properly elected directors who properly appoint the officers?



DUE DILIGENCE: THE BOTTOM LINE

(CONT'D)

- Do they own what they say they own and are there any other credible claims?
- Are there are any hidden obligations to grant equity?
- Are there any unexpected liabilities?
 - Beyond what you would expect for this company at this stage
- Can the issues be resolved for the investment to take place?



THE REAL (NON-LEGAL) BOTTOM LINE

Can they reach their professed
milestones and

Use my money to do so

In order for

*The next round to be at a higher
valuation?*



DUE DILIGENCE CONSTRAINTS

In earlier stages (seed/angel) very little (if any) legal due diligence is performed.

- Legal fees for most VC deals are capped
- The larger the deal, the greater the due diligence.
- Lawyers are always on the hook for results of due diligence.



2.2 DUE DILIGENCE COMPONENTS

- a) *Corporate Actions*
- b) *Existing & planned equity ownership*
- c) *What IP and who owns it?*
- d) *Corporate external obligations/limitations*
- e) *Labor & employment*
- f) *Finances and taxes*
- g) *Other liabilities*



WHY ARE CORPORATE ACTIONS CRITICAL?

- What is the difference between a representation and a warranty?
 - On-going v. at that moment
- “Good standing” *and* the proper exercise of procedures internal to the company.
 - How could a company not be in good standing with the state?
 - Who has to approve the transaction?



REP & WARRANTY

The warranty part of this R&W would be impossible to make:

“The Company is not in material breach of any Material Agreement.”



(A) CORPORATE ACTIONS

- Who recognizes the “creation” of a corporation?
 - What documents show this?
- How does a corporation act?
- Who recognizes the “creation” of a corporation?
 - What documents show this?



(A) CORPORATE ACTIONS (CONT'D)

- By what procedures does a corporation act?
 - What documents are “evidence?”
- Evidence of those corporate acts?
 - What documents are “evidence?”
- Were the directors and officers properly elected?



(A) CORPORATE ACTIONS: ARTICLES

Articles of Incorporation: *Creates* the corporation and (most of) its components

- Valid?
- Adequate number of shares authorized?
Appropriate number of classes authorized?
- Amended/Restated?
- Incorporated in the same state as it does business?
 - Qualified to do business in other state?



CORPORATE ACTIONS: BYLAWS

Bylaws create the *procedures* for the corporation to act:

Shareholders

- meetings
- Voting*
- Restrictions on stock transfers

Board

- election/departure/replacement
- meetings
- Voting*

*Super-majority/vote by class



(A) HOW DOES A CORPORATION ACT?

- Corporate minutes
 - Show that they followed procedures and provided evidence of actions
- Sole incorporator's election of directors?
- Directors initial meeting
 - Election of officers
 - Approval of bylaws/admin actions



(A) HOW DOES A CORPORATION ACT?

(CONT'D)

- Subsequent meetings:
 - Approve increase in authorized capital, amendment/restatement of Articles
 - VC invest in preferred stock: Creation approved?
 - Authorization of any actions on equity, transfer of assets, etc.
- Election of directors & officers
 - Number under California law or Delaware law?



(B) EQUITY

Existing Equity Ownership

- Who has stock, what class, what rights
- Any side letters?
- Convertible notes
- Odd issues: Hypothecated? Spouses without spousal consent?
- Stock options: issued/exercised?

Cap table

Future Promises

- Convertible notes
- FFF promises
- % promises?



#3—P.155

- (a) Prior to the execution of the Assignment Agreement, who owns the business plan [etc.] and other IP?
- (b) Based on the assignment agreement, what more would you want to identify the IP being assigned?
 - Consideration for the assignment?



(C) WHAT IP & WHO OWNS IT?

What is the core IP for the next phase?

- How is it characterized & protected?
 - e.g., NDAs and trade secrets (DTSA)

Who owns it and who could have claims of ownership or other rights?

- Ownership at creation? For developments?
- Assignment/other transfer?
- University-based?



(C) WHAT IP & WHO OWNS IT?

(CONT'D)

Any outbound licenses affect the IP?

- Exclusivity? Enhancements? Joint dev agreements?

Any inbound licenses create critical IP?

- What kinds of rights are granted?

(3)(a)-(b)

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(D) EXTERNAL OBLIGATIONS

How critical are these obligations?

Who?

- Joint development agreements
- Supplier/Vendor
- Customer/Distributor

Restrictions

- Inbound/outbound IP (License v. Cloud)
- Assignment/M&A
- Term & Termination

Liabilities, e.g.

- Indemnification
- SLA levels
- Returns



NO FINDERS!!

No Finder's Fees. Each party severally represents to the other parties that it neither is nor will be obligated for **any finder's fee or commission in connection with this transaction.** Each Purchaser shall indemnify, defend, and hold harmless [. . .]



(E) LABOR & EMPLOYMENT

Agreements in place

- Offer letter
- Employment contract?
- Assignment & IP agreement?

Policies in place

- Employee Handbook
- Employment law posting

Compliance with state & federal law

Employees v. Independent contractors



(F) FINANCE & TAXES

Skip!!



(G) OTHER LIABILITIES

Physical plant/manufacturing:

- Inventory risk
- Pollution liabilities
- Workers compensation

Patent/trademark challenges overseas

Data security

- Previous breaches
- Specialized obligations, e.g., HIPAA, bank regulations
- EU/non-US data security



2.3 CONSEQUENCES & SOLUTIONS

Typical consequences:

- Last-minute scramble
- Delayed closing
- Changed pricing and/or control

Solutions:

- Stronger reps & warranties (if an investment purchase) + schedule of exceptions
- Multiple unanimous written consents
- Cancel the deal



REPS & WARRANTIES SOLUTION

The Company hereby represents and warrants to each Purchaser that, *except as set forth on the Disclosure Schedule attached as Exhibit D to this Agreement* (the “**Disclosure Schedule**”), if any, which exceptions shall be deemed to be part of the representations and warranties made hereunder, the following representations are true and complete as of the date of the Agreement Date, except as otherwise indicated.



PART 3. BASIC ELEMENTS OF THE DEAL

3.1 Entry (Investment) Conditions

- *Type of Entity*
- *(Probable) Industry*
- *Type of Investor*
- *Requirements for the Company (Expectations)*
- *Founders' skin in the game*

3.2 Corporate Governance

3.3 Later Financing Rounds

3.4 Exit



Q B(1): (P.163)

Angel Investment (p.163)--Why would experienced California angel investors *not* invest in this deal?



3.1 INVESTMENT CONDITIONS

Type of Entity:

- Delaware C corp

(Probable) Industry:

- Molecules (usually) lose



3.1 INVESTMENT CONDITIONS

Type of Investor:

- Smart enough to lose it all
- Need an investment or subscription agreement with rep re: accredited investor

Amount & type of equity

- Common or Preferred stock ~20% of total common stock



3.1 INVESTMENT CONDITIONS (CONT'D)

Company condition:

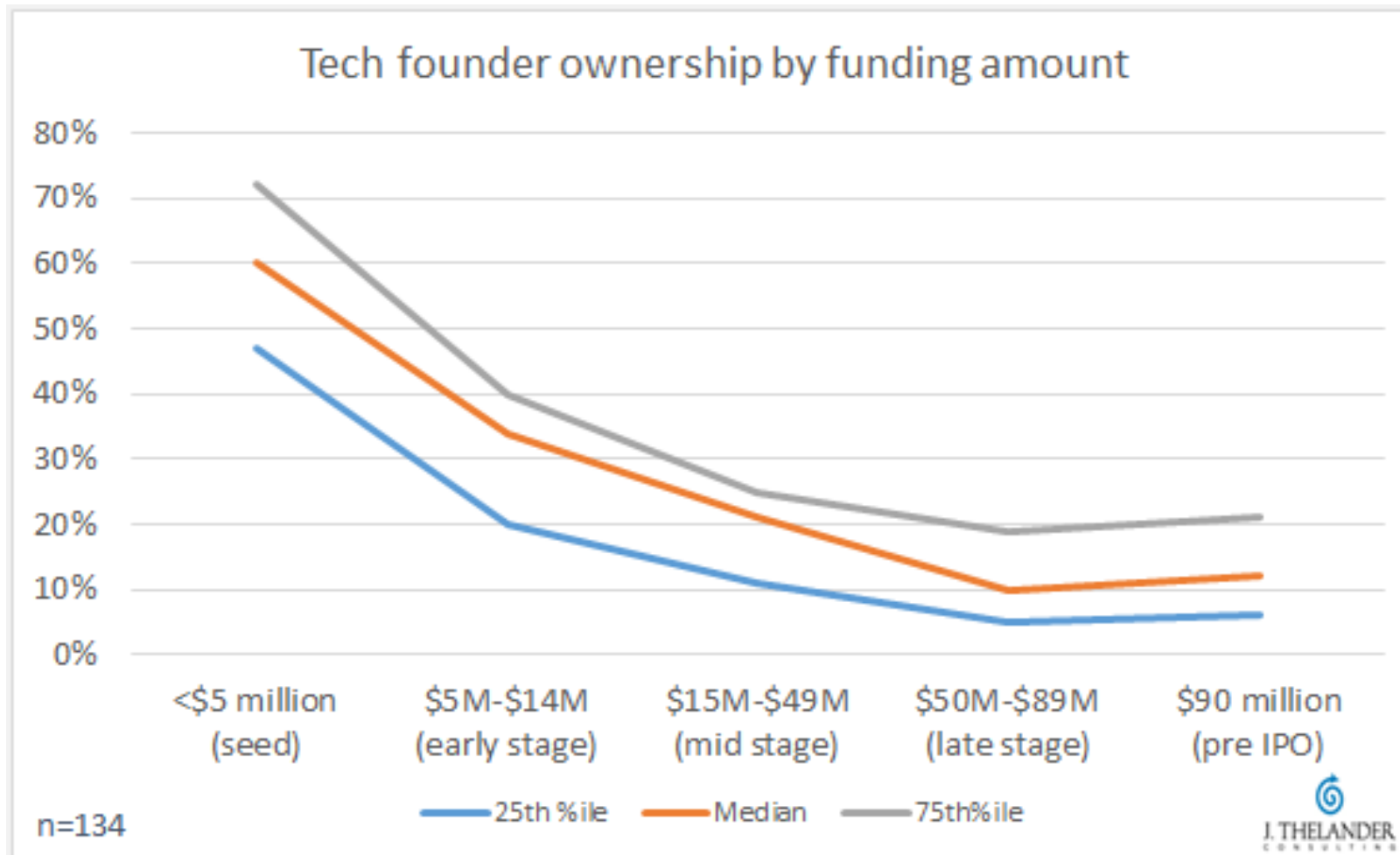
- Clean due diligence book (or understanding of issues)
- Clear path of milestones

Reverse Vesting for founders:

- Founders' skin in the game



FOUNDERS' EQUITY: LOWER PERCENTAGE/HIGHER VALUE



3.2 CORPORATE GOVERNANCE

Investors will want:

- All corporate documents in place
 - *Complicated if preferred stock*
- Board >5 members
- Lead Investor wants board seat
 - *Seed/angel not often*
 - *Alternative: observer status*



3.2 CORPORATE GOVERNANCE (CONTD)

Investors will want *control*:

- Limitations on corporate actions by board
- If preferred stock, then bylaws specify that “major decisions” must be approved by majority vote of each class
- Common: super-majority & shareholder agreement*

Delaware law: Cannot compel directors to vote a certain way



Q#4 ON P.168 AND THE CAP TABLE

- How could Sally gain control?
- If she has preferred stock, how could she already have control?
- In what documents would you find that control?



3.3 LATER VC ROUNDS: PROTECTION

- Anti-dilution provisions--which mean contractual protections of stock %
- SAFE Agreements (all convertible notes) usually prevent subsequent rounds without approval if under a certain %
- “Down round” could mean larger percentage but always means founders lose



3.4 EXIT

- Exit (almost) always means conversion to common
- If successful exit, seek to drive or participate in exit
 - Tag along/drag along rights
 - registration rights
- Certain multiples of value of preferred stock investment before shared with common shareholders



PART 4. THE (NON)ISSUE OF VALUATION

- Pre- and post-money valuations always seem to be a major issue.

It's a non-issue

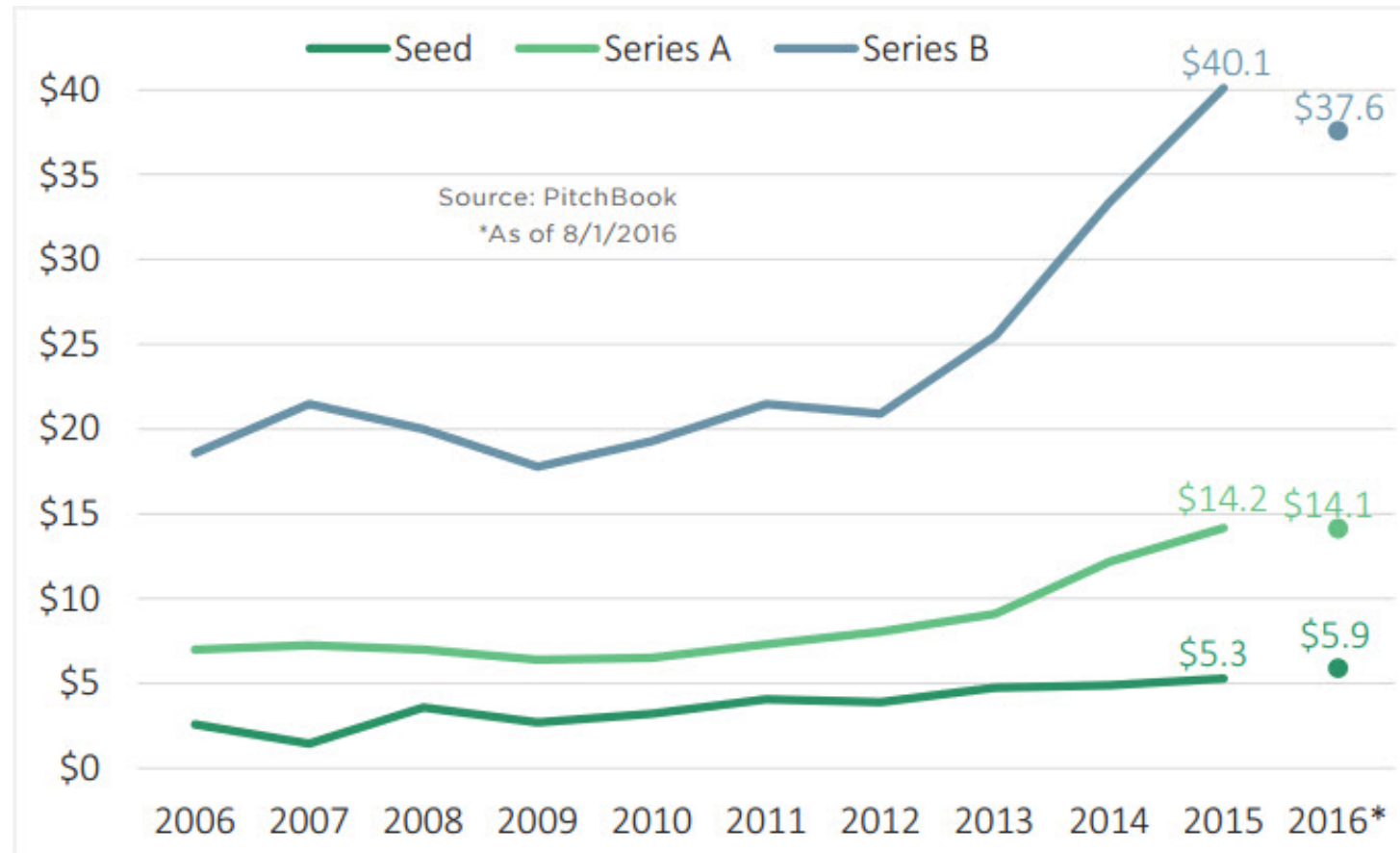
- VC, as a mature industry, has pretty much determined the math.

Lower valuation from a great VC is OK

- Main rules-of-thumb:
 - Leave space for future rounds
 - Founders need to share in the upside



MEDIAN EARLY-STAGE PRE-MONEY VALUATIONS (\$M)



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ANOTHER LOOK AT PRE-MONEY

Pre-Money Valuation as of 9/15:

Series A	19.0
Series B	56.0
Series C	128.0
Series D	400.0



THE VALUATION MATH

Assume the following pre-funded startup:

1,000,000 shares:	3 founders
VC fund offers:	\$5 million
Post-money valuation:	\$15 million
Implied pre-money:	\$10 million



VALUATION MATH (CONT'D)

Initial shares equal to:

$$\frac{\text{Pre-Money Valuation}}{\text{\# shares outstanding}} \longrightarrow \frac{\$10,000,000}{1,000,000} = \$10 \text{ per share}$$

Investor receives:

$$\frac{\text{Investment}}{\text{Pre-Money Price Per Share}} \longrightarrow \frac{\$5,000,000}{\$10} = 500,000 \text{ shares}$$



VALUATION MATH (3)

Post-money results:

- 1.5m shares outstanding
- 3 founders (1m): 67% ownership



VALUATION: ROUND 2

1,500,000 shares (pre)

VC fund offers: \$10m

Post-money valuation: \$30m

Implied pre-money: \$20m

Initial shares equal to: \$13.33 pre-money

New shares issued: 750,000

Total shares issued: 2.25m

– (\$10m/\$13.33)

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VALUATION: ROUND 2 (CONT'D)

Shareholders	Shares issued	Percentage
Founders:	1,000,000	44.445
VC #1	500,000	22.222
VC #2	750,000	33.333
Total shares	2,250,000	100.00

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EV, INC.

Assume:

- EV, Inc., is authorized to issue 1,000 shares
- Ian Gorton and Betty Paul each pay \$5,000 for 250 shares each
- Those are the only shares issued



P.153-155: VALUATION (CONT'D)

- Is it possible to calculate the pre-money valuation of EV?
- Upon issuance, what percentage of issued shares do they each have?
- What's the post-money valuation of the company?

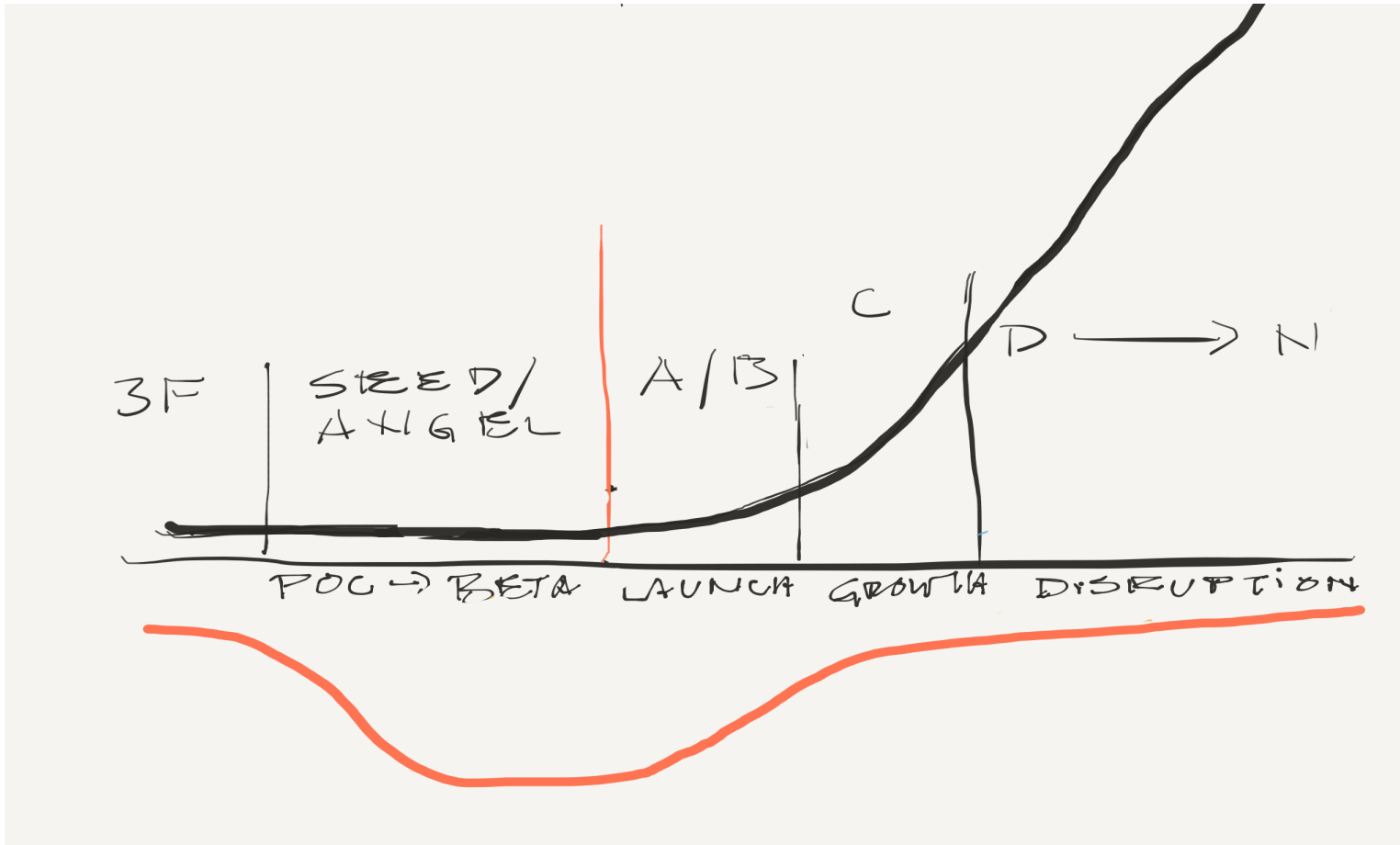


PART 5. CORE DEAL DOCS

- 5.1 Deal Doc Purpose(s)
- 5.2 A Quick Look at the Term Sheet
- 5.3 A Quick Look at the Cap Table
- 5.4 3 Investment Instrument Options



ORANGE IS THE NEW BLACK



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5.1 BASIC ADVICE ON THE DOCS

What are the documents *supposed* to do?

- What is the purpose of *each* document?



5.1 DEAL DOC PURPOSE (CONT'D)

*To get the deal done on the terms
agreed upon*

Which includes

Reaching reasonable agreement on
protecting the investment



5.1 PURPOSE BY DOC (CON'TD)

Term Sheet	Everyone starts on the same page on the crucial points
Cap Table(s)	All the shares are accounted for, before & after investment
Amended Articles	That the company creator (state) has granted the rights needed to do the deal
Board minutes	That the company acted in the manner necessary and sufficient to do the deal



PURPOSE BY DOC (CON'TD)

Investment agreement

That the parties have agreed to the terms of the investment, including: rep on accreditation (investor); reps & warranties on major elements of the company

Investment instrument

That the precise terms of the investment, and rights granted therefor, are specified to the extent necessary to withstand a successful legal challenge as to financial instruments



5.2 A QUICK LOOK AT THE TERM SHEET

Pick 3-5 issues and negotiate those, e.g.:

- **Anti-dilution:** Best VCs have the best terms—protection only against downround valuations
- **Founder vesting:** Protect your time to date (50% already vested?); include only “bad leaver” terms that are narrow
- **Binding v. non-binding** (“No Shop” clause)



5.2 TERM SHEET ISSUES (CONT'D)

The Devil is in the details:

- “Additional standard terms shall apply” is too vague

The Devil is in Delaware:

- **Non-binding? Nope:** *SIGA Techs., Inc. v. PharmAthene, Inc.*, Case No. C.A. 2627 (Del. Supreme Court May 24, 2013)

Binding as to no-shop, etc., and the rest is guidance?

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5.3 A QUICK LOOK AT THE CAP TABLE

Generally if 1:1 conversion then “total shares” = all shares.

- If different, then need “nominal” and “as converted columns”
- Note equity incentive plans always included



CAP TABLE EXAMPLE

WorldState, Inc.				
Capitalization Summary				
Authorized Shares:		12,000,000		
Outstanding Shares:		8,000,000		
Shares Reserved for Stock Option Plan (Pool):		2,000,000		
Remaining Unissued Shares:		2,000,000		
Name	Common Stock	Stock Options	Fully Diluted Shares	Percentage of Fully Diluted Shares
Bernard Marx	4,000,000	0	4,000,000	40.00%
Helmholtz Watson	2,000,000	0	2,000,000	20.00%
Lenina Crowne	2,000,000	0	2,000,000	20.00%
Mustapha Mond	0	200,000	200,000	2.00%
<i>Remaining Pool</i>	<i>0</i>	<i>1,800,000</i>	<i>1,800,000</i>	<i>18.00%</i>
Total	8,000,000	2,000,000	10,000,000	100.00%
Percentage Ownership	80.00%	20.00%	100.00%	



5.4 3 INSTRUMENT OPTIONS

Convertible Note
SAFE Agreements
Seriesseed v3.0



5.4 INVESTMENT INSTRUMENT: CONVERTIBLE NOTE V. SAFE* (CONT'D)

Convertible note: debt instrument, which means

- Principal + interest
- Maturity date
- Math for conversion

SAFE is an option (or warrant), so has none of the above aspects

People love and hate SAFE agreements

**(Simple Agreement for Future Equity)*



5.4 CONVERTIBLE NOTES

They like:

- Some control over pricing
- Conversion can be into current stock (“Qualifying transaction”)
- Less control by the investor

But

- Heavily negotiated upfront (costs money)
- Firm maturity date
- Pay interest (increased % of equity)



5.4 CONVERTIBLE NOTE FEATURES (CONT'D)

- Interest:** 6-10% though recently 1-2%, but (probably) *something*
- Maturity:** 2-3 years (minimum)—period to raise next round, but also repayment date
- Conversion:** Qualified financing; conversion cap + discount rate (whichever results in lower price)
- Combine preferred and common (limiting stock to \$ of liquidation preference)



NOTE CONVERSION PROVISION

It's not in the note:

1. **Maturity.** Unless earlier converted into Conversion Shares pursuant to Section 2.2 of, the Purchase Agreement, the outstanding principal and accrued interest shall be due and payable by the Company on demand by the Majority Note Holders at any time after the Maturity Date.



5.4 SAFE AGREEMENTS

They like:

- Absence of debt instrument components
- Lower cost
- Conversion into *future* equity

But

- Not as well-known
- Not as simple as they suggest (still usually have to do valuation “stuff” e.g., valuation cap & discount rates)

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5.4 SAFE AGREEMENT FEATURES

Interest:	Not applicable
Maturity:	Not applicable
Conversion:	Any preferred raise
Limits:	With a valuation cap, liquidation preference capped at total \$ invested

(Series Seed docs ~ “mini-Series A”)



THANK YOU.

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