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# 50-50 STARTUPS: INTRODUCTION TO KEY LEGAL AND FINANCING BASICS

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# What We Will Discuss

During this Presentation we will review:

**Key Points in the Lifeline of a Company**

**Common Legal Mistakes** that may complicate raising money

**Preparing for Due Diligence** by investors

**Financing Basics** for angel and venture capital investments

**Forms of Investment** including principal documents, critical terms and key differences

**Brief introduction to Impact** Investing to mission-related enterprises

***This presentation is with a U.S. investor point of reference. There may be jurisdictional deviations where your entity is formed, and some of these points will need to be adapted to your local environment.***

# Lifeline of a Company

**Entity Start-Up**
- Choice of Entity
  - Limitation of liability
  - Tax matters
  - Jurisdiction
  - Holding Company

**Initial Capital**
- Founder Funded
- Friends & Family
- Crowd-funding
  - Donations
  - Equity
- Loans
- Grants
  - Governments
  - NGOs

**Angel Funding**
- Convertible Notes
- SAFE
- Small seed round of preferred stock

**Venture Capital**
- Series A Preferred Stock Investment
- Follow on preferred rounds

**Maturity/Exit Event**
- Sale of Business
- IPO
- Structured exits
  - Redemptions
  - Royalty arrangement
  - Revenue Share Agreements

# Selecting the Appropriate Entity is Critical

**Selecting the right business entity is critical**

- Setting up the right business entity for the company is important. This will mean seeking counsel of a lawyer and a tax professional in your jurisdiction.
- Preference for U.S. Holding Company
  - One approach non-U.S. companies have taken to facilitate investment by U.S. investors is to set up a U.S. holding company.
  - This makes it easier for U.S. investors to invest who are unfamiliar with foreign entities and therefore making it easier for the company to find investments. There are likely to be tax implications of this and you will need to seek legal and tax counsel.
- Any entity managed and controlled in Israel is considered an Israeli resident for tax purposes.

# Common Legal Mistakes & How to Avoid Them

**These are mistakes to avoid because they can complicate your company's ability to raise money**

- **Not involving lawyers and tax professionals early on**
  - A common sentiment in the start-up space is to focus on raising money fast, leaving the legal and tax concerns for later "when there is cash". This usually results in start-ups taking advice from other start-ups on legal and tax matters, which may or may not be the correct advice for your specific positioning. Many things can't be undone cheaply, or at all, so don't skimp on legal and tax counsel! Special attention is needed to intellectual property so that it is properly owned by the start-up.
- **Not forming the entity soon enough**
  - It is important to have an entity ahead of any investments or creating significant value in the company; otherwise there can be adverse tax consequences.
- **Setting up the business incorrectly from the beginning**
  - Redoing or changing the entity later can be very difficult and costly. Moreover, some consequences are not "undoable".

# Common Legal Mistakes & How to Avoid Them

**Starting the business while employed in the industry, potentially with a competitor, or while being on the staff of a government owned hospital, university or other institution**

- Many contractual agreements you may have signed could include ownership over your creations.

**Not executing a Founders Agreement/Shareholders Agreement**

- Determining fundamental terms of the relationship such as roles and responsibilities, decision making and voting rules, equity splits, contributions, structure around an exiting founder, buy back of shares, etc.
- Forgetting an original founder
- Issuing founder shares without an incentivizing vesting schedule

**Failing to keep proper business records**

- It is important that you keep competent unaudited financials
- You should always keep an updated and complete capitalization chart
- Keep board meeting notes, recording big decisions, records for tax purposes, etc.
- Save all contracts with signatures and exhibits.

# Common Legal Mistakes & How to Avoid Them

- **Bringing in outside investors too soon in the capital structure and governing structure & not thinking about the right investors with proper view of company**
  - Make sure the business is off and running before soliciting investors. You don't want investors frustrated that they have invested and aren't seeing results.
  - Don't just jump at anyone who offers money because you are desperate for cash.
  - You want to make sure the investors are a good match for the company. Disagreements with investors on running the company and goals can be detrimental to the company.
- **Giving out equity too easily to employees/founders & not being able to get it back**
  - Be thoughtful when incenting employees with equity.
  - Consider putting restrictions on it & recourses for getting the equity back when people leave the business.
- **Over-promising what the business can deliver to investors**
  - You need to manage expectation of your investors and maintain your credibility for future rounds of funding.

# Common Legal Mistakes & How to Avoid Them

- **Failing to prepare for employment issues**
  - Correctly classify independent contractors, employees, interns, and volunteers. These are *not* interchangeable positions and have very specific requirements for each.
  - Pay everyone properly and report payment to government agencies.
  - Know law governing required employment postings, wage and hour requirements, harassment training requirements, union regulations, privacy laws.
  - Have a good employee manual and HR policies.
  - Sign employment contracts that include NDAs, non-competes, and valid assignment of intellectual property provisions.
- **Not having a good form for your key agreements (e.g. customer facing and supplier facing agreements)**
- **Not assigning IP to the company**
  - Creation can be in many forms: Source code, object code, logos, processes, inventions
  - And can come from many sources: Founders, Friends, Colleagues, School classes, Thesis Projects, Research backed by University grants or professors, Hired workers, Interns
  - Make sure the creators of the works assign rights for created IP to the company.
    - Licensing Agreement
    - Proprietary Information and Inventions Assignment Agreement (PIIA)

# Common Legal Mistakes & How to Avoid Them

**Not protecting customer data**

-Many jurisdictions have specific requirements on how to properly protect customer data. Examples include General Data Protection Regulation (GDPR), (California Consumer Privacy Act (CCPA). Even if your business is not based in the jurisdiction, if your customers are citizens there, you will need to understand and comply with the regulations.

**Not contractually protecting proprietary information**

-Ensure that important proprietary information is contractually protected

- -Confidentiality Agreement
- -Non Disclosure Agreements (NDA)
- -Understand what Trade Secrets are and how to protect them.

**Not registering IP with the appropriate authorities**

-Get a good IP lawyer and consider registering the IP with appropriate authorities.

- -Trademark, Service Mark, Copyright, Patent

**Not having sufficient cyber security**

-Hackers attack all businesses, you don't your sensitive data or customer data to be leaked. Many jurisdictions have reporting regulations you must follow when hacked, and failure to set up security protocols in accordance with local regulations can sometimes come with hefty fines.

**Ignoring the potential effect of regulations on your business**

# Initial Investors

- Founder funds
- Friends & Family contributions
- Crowd-funding
  - Donations
  - Equity
- Loans
  - Demand Note – An interest bearing loan that does not have a fixed term or repayment schedule and the lender can recall the note, or demand payment, at any time. Lender must give notice pursuant to the demand note agreement.
  - Term Note – An interest bearing loan that has a fixed term or repayment schedule.
  - Convertible notes (which we will discuss shortly)
- Grants
  - Government
    - Special attention to restrictions on the use of know how developed with use of funds from the Israel Innovation Authority
  - NGO

# Angel Investors

- Investor (individually or as part of a group) investing their own personal money in a startup.
- Usually the earliest third-party round of funding.
- Typically angel investments are debt in the form of a convertible note.
  - Israel Tax Authority is taking an aggressive view against convertible loans. Interest is subject to withholding so converting interest is a problem and the discount can be considered additional interest subject to withholding.
- However, they can be equity, such as a SAFE or a seed round.
  - Seed funding is the earliest stage of funding. It pays a company's expenses while it is getting started.
- Important to be very thoughtful whether to use debt or equity to fund capital.
  - Early decisions on equity may be very costly in the long-run.

# Preparing for Due Diligence

Preparing for due diligence is not necessary in the early investor stage, when the investor is usually interested in supporting the person. However, the importance increases in angel funding rounds and increasingly takes a central role in venture capital rounds, IPOs or take outs. Due diligence is important because legal mistakes found in the due diligence process can become a problem and complicate raising money.

- Investors will want to fully understand every aspect of your business. Be prepared.
  - Start early and be organized. Delays and missing information can be viewed as red flags by investors. You want to present the information to them in a digestible form. First impressions are impactful!
  - Be honest about liabilities and address them. Hiding concerns will never end well.
  - Hire an experienced lawyer to manage the process
  - Use a secure online data room to share the information (can be costly!)
  - Keep the information updated as the diligence process continues.

# Term Sheets

| | |
|---|---|
| **Term sheets** | **Term sheets** are an essential part of any corporate financing transaction – whether angel or venture capital financing. |
| **Key information includes:** | – Amount to be Raised<br>– Minimum Amount Accepted<br>– Qualification of Investor<br>– Documentation of Investment<br>– Special rights of Investor<br>– Confidentiality<br>– Exclusivity<br>– Governing Law |
| **Clarity** | **Clarity** as to what is being agreed upon is essential! |

# Types of Debt Investments

## Convertible Note

- An interest bearing note that {may} convert into future equity in the company's next financing or upon the meeting of certain agreed upon terms (but if the terms are not met, it must be repaid in cash at the agreed upon maturity date).
  - As previously noted, in Israel interest is subject to withholding so convertible interest is a problem and the discount can be considered additional interest subject to withholding

## Simple Agreement for Future Equity (SAFE)

- An equity alternative to convertible debt instruments, generally considered equity but are not really either debt or equity! A SAFE will result in the issuance of shares at the next equity financing, if no equity financing occurs, typically no trigger for repayment or conversion results.

# Key Terms & Characteristics of Debt Investments

- **Advantages for Company**
  - Allows company to defer establishing a valuation.
  - Ownership dilution is deferred until some later date and company gets to use the proceeds of the note to increase the value of the company today.
  - Typically a faster (and also a less expensive) option to a more traditional equity investment.
  - Interest payments may be "paid in kind" so may not involve cash outlay at each interest payment date. Note: this is a tax withholding problem in Israel.
  - Company may be able to negotiate the ability to voluntarily prepay the note (and therefore avoid having it convert to equity)
- The company wants to retain the option of potentially paying the note back in cash rather than having it convert to equity.

# Key Terms & Characteristics of Debt Investments

- **Areas of Concern for Company**
  - Determining appropriate maturity date, valuation cap and discount rate.
  - Company has a limited time frame before the note needs to be repaid; if the conversion event has not occurred at maturity, the investors could elect to renegotiate terms (rather than accelerate) but company is at a disadvantage in terms of negotiating leverage.
  - Investor could impose default triggers in note which could mean that loan becomes due before stated maturity.
  - Sets a definitive time frame by which the investment either converts to equity or gets repaid.

# Key Terms & Characteristics of Debt Investments

## Advantages for Investor

- Sets a definitive time frame by which the investment either converts to equity or gets repaid.
- A convertible note also provides the investor with the protection of debtholder status until it is converted into equity (unlike a SAFE).
- Permits investor to get in at early stage prior to parties having to value Company.
- Valuation caps can add a layer of protection to investor upon conversion.

# Key Terms & Characteristics of Debt Investments

## Areas of Concern for Investor

- Determining appropriate maturity date, valuation cap and discount rate.
- Investor believes the equity trigger is unlikely to occur (or at least not during the life of the note).
- Investor believes the interest rate is too low (the investor could invest in less risky similar entities and produce the same or a greater return).
- The proposed valuation cap is viewed as being too high.
- The proposed discount rate is viewed as being too low.

# Simple Agreement for Future Equity (SAFE)

- A SAFE is a simple agreement that provides investors an opportunity to invest now but receive shares in the future. It is essentially like a convertible note, but is never repayable and can be considered and be treated like equity.
- A SAFE is not a debt instrument and while not strictly equity – it is largely considered to be equity.
- A SAFE is treated like other convertible securities, *i.e.*, warrants and options.
- Converts to "SAFE preferred stock" when <u>any</u> amount is raised in a preferred equity round. Conversion is automatic and terminates the SAFE.
- Allows for a discount to be applied to the future valuation associated with the preferred equity round.
- Allows for the SAFE preferred stock to be issued at the better of the discounted valuation (using the stated discount) or a pre-negotiated valuation cap, whichever is more favorable at the time of conversion.
- Offers payout or conversion to common equity if there is a change of control event prior to conversion to preferred equity.
- No termination or maturity date. If preferred equity is not sold, SAFE remains in place.
- SAFEs can have default provisions which trigger repayment like insolvency.

# Differences Between SAFE Preferred Stock and Standard Preferred Stock

- SAFE preferred stock will usually be a separate subseries of the series of standard preferred stock being issued in the equity financing in which the SAFE converts (e.g. such as Series A and Series A-1 preferred stock).
- SAFE preferred stock will have the same rights, privileges, preferences and obligations as the standard preferred stock, <u>except</u> the liquidation preference, conversion price and dividend rate will be calculated based on the price per share of the SAFE preferred stock.
- The per share price at which the SAFE converts into equity will be the initial liquidation preference and conversion price of the SAFE preferred stock, which will be <u>lower</u> than the price at which new investors purchase equity in the financing, reflecting the discount on the SAFE.

# Key Terms & Characteristics of SAFEs

## Advantages for Company

- No money owed to investors because the company is not borrowing, so no debt on balance sheet.
- No interest payments to investors, but the company can choose to make discretionary dividend payments.
- No set maturity date.

## Areas of Concern for Company

- Increasing the number of outstanding shares dilutes the ownership of existing shareholders and gives away a piece of the pie.
- Important to track SAFE commitments and ensure the dilution implication is considered in connection with the first equity round or conversion can occur.

# Key Terms & Characteristics of SAFEs

## Advantages for Investor

- Easy to negotiate, saving time and money – need to decide amount to invest, discount rate and valuation cap.
- Converts to SAFE preferred stock when a preferred round of equity is raised no matter how much preferred equity is sold.
- Option to convert to common equity or be paid out if company is acquired.

## Areas of Concern for Investor

- No term or maturity date – if preferred shares are not issued, could remain in limbo.
- No interest accrual.
- If dividends are paid on common stock prior to the preferred equity round, the SAFE investor will not participate.
- Not entitled to regulatory protections associated with other investment options.
- No investor protections like information rights or rights to participate in future funding rounds.

# Type of Equity – Common Stock

- Common Stock provides voting rights. (This is referred to as ordinary shares in Israel).
- Common Stock typically used for founder's equity, also used for employee incentive plans in lieu of cash (younger companies that have less cash will rely more heavily on creating equity incentives for retentive value).
  - Note: Common stock option awards issued through incentive plans will still need to be purchased to exercise an option.
- Common stock is typically granted or earned through equity awards.
- Employee incentive plans must comply with local law so that employees receive favorable tax treatment.

# Type of Equity - Preferred Stock

- A purchased equity investment
- Preferred Stock provides has voting rights (typically on an as-converted basis)
- Provides a liquidation preference in bankruptcy
  - Ensuring the better of the bargain, can take as preferred or common upon liquidation)
- VC financings are typically preferred stock
  - Information/observation rights
  - Board representation
  - Protective provision
  - Redemption rights (these are a bit complicated in Israel)
  - Pre-emptive rights
  - Drag along rights
  - Registration rights
  - Accrues dividends
    - cumulative vs. non-cumulative
    - compounding vs. non-compounding

- There are two types of preferred stock:
  - Straight Preferred
    - Higher of (i) money in plus accrued dividends **and** (ii) common stock equivalent
  - Participating Preferred
    - (i) money in plus accrued dividends **plus** (ii) share with common on common stock equivalent basis
    - Multiples – e.g., double money in and then share.

# Financing Deal Documents

- Demand Note
  - Demand Loan Agreement

- Convertible Note
  - Note Purchase Agreement
  - Convertible Promissory Note
  - Alternative: Convertible Loan Agreement

- Simple Agreement for Future Equity ("SAFE") and Related Materials – Y Combinator forms

# Key Terms of Venture Capital Investment

- Venture Capital
  - Investment professionals actively managing institutional investor money
  - A seed round can be by an Angel or VC (pays expenses when just getting started)
  - VC's typically invest in Series A and later series of Preferred Stock
  - Requires a valuation of the company and deriving the price-per-share
- The pre-money valuation is used to determine the share price the investor will pay in the round.
- "Pre-money shares"
  - Founder stock, stock option pool, convertible notes, warrants, conversion of founder debt
- The share price is determined by dividing the pre-money valuation by the number of "fully diluted" shares outstanding. The pre-money valuation, plus the amount of the investment is referred to as the "post-money valuation".
- "Fully diluted shares outstanding" is a very important concept and can include shares issuable upon exercise or conversion of a variety of different securities: outstanding options, unissued option pool, warrants, convertible notes and preferred stock, all with potentially complex exercise and conversion terms.
- "Post-money valuation" calculates the worth of the company after the investment.

# NVCA Based Financing Documents

**National Venture Capital Association ("NVCA") Forms**

- Base forms used in Venture Capital Series Financings written and updated by the National Venture Capital Association

**Common Stock & Preferred Stock**

- Amended and Restated Certificate of Incorporation (Referred to as the Articles of Association in Israel)
- Common/Preferred Stock Purchase Agreement
- Investors' Rights Agreement
- Voting Agreement (Not required in Israel – appointment of directors can be included in the Articles)
- Right of First Refusal and Co-Sale Agreement (Not required in Israel – can be included in the Articles)
- Management Rights Agreement (required by some VCs for regulatory reasons)
- Director Indemnification Agreement

# What are the Logical Exits?

- Follow the money!
  - Note, unless an investor's focus is an impact mission, an investor is always going to be looking primarily for the best possible return on their investment.
- Traditional paths to exit – what is feasible in the desired timeline?
  - Acquisition – sale of the business
  - IPO
  - Sale of Assets
- Alternative ways to structure an exit or a return for the investors that may be attractive:
  - Certain mandatory redemption rights given to the investors (require the company to repurchase the debt/equity held by the investor at some future time and subject to certain conditions)
    - Note, there are several complications using this in Israel including that redeemable shares sit on the balance sheet as debt, not equity
  - certain sale rights if others are able to sell their positions
  - or rights to participate in the profits of the venture
- Revenue generating entity and will to continue operating – no need to exit!

# What is Impact Investing?

- "Impact investments are investments made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return." -*Global Impact Investing Network*
- Impact investments are investments, not grants or gifts.
- The premise is that financial terms afford discipline and structure and act as an incentive to achieve the desired impact as well as financial gain.
- There is an expectation of a return *of* capital and a return *on* capital, and a desire to achieve social and/or environmental benefit.
- Compromise on the degree of returns may reflect concessions if impact goals are achieved.
- Conversely, there may be early termination or penalties if goals change.

# How Do We Measure Impact?

- Figuring out how well the company is doing financially is the easy part. The more difficult aspect is measuring impact.
- A B Corp. is one method. Note this is not a type of legal entity, but more of a designation. A company that becomes a B Corp takes a detailed self-audit and reports to B Lab, which is a non-profit organization which, among other things, created and awards entities with a "B Corp" certification—the "B" stands for beneficial and indicates that the entity that has this certification voluntarily meets, according to B Lab, "rigorous standards of social and environmental performance, accountability, and transparency".
- Another method is the Global Impact Investing Rating System ("GIIRS"), which provides impact ratings to companies. The ratings are based on a use of various performance data and metrics used in conjunction with other criteria to come up with a rating.
- There are many impact investors that have or are in the process of developing their own methodology for measuring impact.
- Measuring impact continues to be a challenge, especially in early stage companies. Even for those which provide their investors with an impact report, the report may not be very specific or comprehensive, as impact assessments are not easy to do. They are very specific to each investment. No one-size-fits-all metrics!

# Embedding Impact Mission into Debt Instruments

Note could provide for a clear understanding of mission and set firm deadlines for meeting certain mission goals and note implications for missed benchmarks.

Investor may require periodic financial reporting to evaluate investment and financial condition of the company, as well as detailed updates on the status of the mission.

The note can provide interest rate discounts or other financial incentives (including increasing valuation cap) if certain mission targets are achieved prior to set dates.

The note can provide interest rate increases, valuation cap decreases, prepayment terms, the ability to accelerate repayment, or no ability to automatically convert into equity if mission targets are missed or otherwise deviate beyond approved goals.

# Embedding Impact Mission into Equity Financing Documents

- Could provide for a specific impact goal and set firm deadlines for meeting certain mission goals.
  - If goal is **not** achieved or the company deviates from the impact mission, the documents could provide for payout, increase the discount rate, or decrease the valuation cap that is used at the time of conversion.

# QUESTIONS?

# Biography

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Carl Valenstein is a partner at Morgan Lewis & Bockius LLP and is the leader of the Boston Corporate Business Transactions Group and Co-Leader of the Firm's ESG and Sustainability Initiative. His practice focuses on domestic and international corporate and securities matters, mergers and acquisitions, project development, and asset finance covering a wide range of industries and regions, including developed and emerging markets (Latin America and Africa). He also counsels clients concerning international risk management issues and has been involved in internal investigations and enforcement cases in this area. Carl is fluent in Spanish and Portuguese, and conversant in French and Italian.

For more than 20 years, Carl has provided legal assistance to microfinance institutions and assisted public charities, foundations, social enterprises and entrepreneurs, impact investment venture capital funds and other impact investors. He is a founding member of the Impact Investment Lawyers Legal Working Group, which holds annual conferences. Carl is an Adjunct Professor at the University of Michigan Law School and New York Law School International Transactions Clinics (ITCs) focusing on impact investment. In conjunction with the Michigan Law School ITC, he represented Habitat for Humanity International in establishing MicroBuild, a $100 million dollar fund that expands housing microfinance lending and helps thousands of low-income families globally. The fund received the Overseas Private Investment Corporation's (OPIC's) 2016 Access to Finance Award and recognition by the Financial Times for Social Innovation. He represented Jewish Vocational Services in the third Massachusetts pay-for-success contract. He serves on the Advisory Board of the Michigan Social Venture Fund and NU Impact Fund. He represents 50 50 Startups in general corporate and impact investing initiatives.

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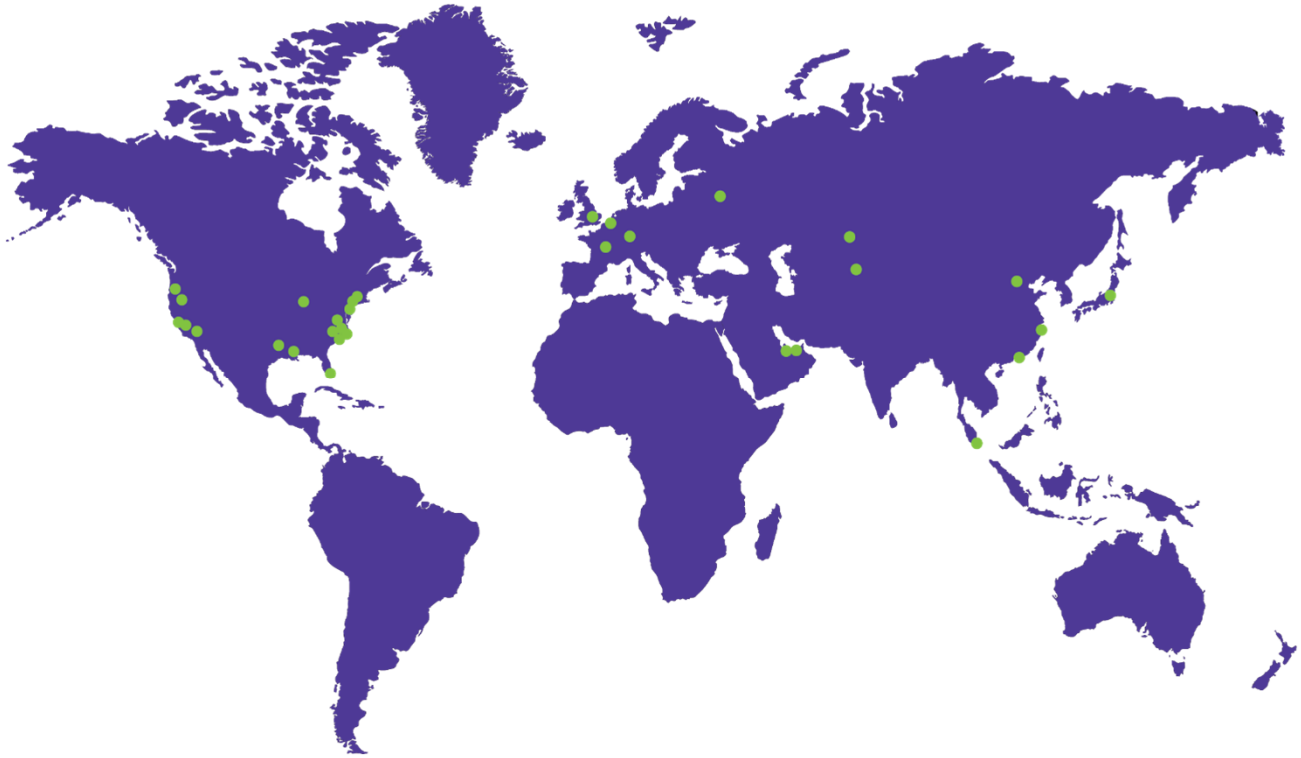
Jennifer L. Webb works with public and private companies on a variety of transactions including mergers and acquisitions, joint ventures, financings, restructurings, and other complex transactions across a diverse range of industry sectors. She also counsels companies on ongoing corporate matters, including corporate governance and SEC compliance. Jennifer joined the legal profession after gaining extensive experience from her prior career in business operations and financial analysis. While attending Boston University School of Law, she represented startups and non-profit companies in the Startup Law Clinic. She represents 50 50 Startups in general corporate and impact investing initiatives.

## Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

## Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore*
Tokyo
Washington, DC
Wilmington



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# THANK YOU