

Helping Your Business Clients Attract Outside Capital

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I. What this Seminar is About – a Tale of Two Entrepreneurs

A. Two Typical Scenarios

Two different clients called you today, with similar requests. The first client, Bill Gates IV, has invented “the next big thing.” He has already researched the market, prepared a business plan, built a prototype, and even made some sales to one or two customers. But that effort has consumed all of his savings, and all of the money that his friends and his father (Bill III) are willing to put into the business. More funds are needed to refine the product, further develop the market, and ramp up sales.

The second entrepreneur already has an operating business. In her case, personal savings and the “friends and family” funding was enough to get her business to the point of cash flow positive operations. But, she is focused on the local southeast Michigan market. She now wishes to grow this business into the Midwest and beyond. She, too, needs more expansion capital.

Each entrepreneur calls to obtain your help. How can you help your clients?

II. Angel Investors – Where to Turn When Friends and Family Say No (Or, They Stop Saying Yes)

A. Overview of the World of Entrepreneurial Finance

Most entrepreneurs fund their startups in predictable stages (this is primarily because of the cost and availability of equity capital at various growth stages of a startups’ life cycle).

The typical stages are:

1. **Founder Money.** This includes the founder’s personal savings, credit card borrowing, home equity lines, and “bootstrapping” (that all-important entrepreneurial flair for bartering goods and services, and otherwise leveraging resources; bootstrapping also includes obtaining “funding” from customers and suppliers in the form of open account credit, etc.). Founder money is used typically at the pre-seed stage (developing business plans, working on prototypes, etc.).
2. **Friends and Family Round.** Sometimes this is (unfairly) called the “friends, fools and family round. This is money from people who love you. They may be enthusiastic about your idea, and may or may not understand it, but they’ll mostly be investing because of you and your DNA (same as theirs). The friends and family round is also at the pre-seed stage, and into the seed stage (development and perhaps finalizing the prototype, perhaps even to first revenue).
3. **Angel Investors.** These are typically wealthy individuals (often themselves successful entrepreneurs), who will invest individually \$50,000 to \$75,000, and

collectively \$500,000 to \$750,000, in a promising venture. They are the focus of our discussion today. Angel Investors will occasionally invest at the pre-revenue stage, but most often invest after the Company has turned the revenue corner. Your client should expect the timetable to close an Angel round of financing (from first review of business plan to funding) to easily take 60-90 days.

4. **Venture Capitalists.** These are professional money managers, investing other people's money at the growth/expansion stage. A typical venture capital round will raise \$5 million plus (each individual investor putting in as much \$3 million).
5. **Private Equity.** These are also professional investors of other people's money, focusing on later stage companies with established, stable cash flows. Private equity typically invests in later stage companies than venture capitalists. And often expect their investment will take five years or more to mature.
6. **IPO or Merger.** This is really the classic "exit device" for the entrepreneur. Either initial public offering (a public registration of the equity in the entrepreneur's business), or a merger with a larger Company (often through an exchange of the larger Company's publicly traded stock, for the entrepreneur's privately held enterprise).

B. What Do Angel Investors Look Like; More Importantly, What Are They Looking For?

Angel Investors are typically wealthy individuals, often themselves successful entrepreneurs, who should provide "value added capital" to the entrepreneur and her business. "Value added capital" means that the angel's contacts and business advice are as valuable to the Company as the angel's funding. An April 2006, survey by the Angel Capital Association reports that, on average, an angel invests approximately \$35,000 per deal, but typically pools his or her investment with other angels to provide \$375,000 to \$400,000 per Company.

According to the Center for Venture Research (University of New Hampshire), prior to 1998, angels were typically in their early 60's and almost always male. By 2003, angels got younger! Now they are typically in their early 50's, and more and more women are becoming investors in the angel market. Women tend to be more careful investors: in 2002, the Center for Venture Research (University of New Hampshire) reports that male angels fund about 7.1% of all the deals they look at, whereas women angels are choosier and more careful, as reflected in their 5.2% rate of deals funded versus proposals presented.

Angel funding is expensive: given the risks involved in angel investing, 8 out of 10 investments would either be a total loss or would barely return to the investor his or her invested capital; therefore Angel Investors typically look for the investment to produce 40% to 70% internal rates of return (based on the entrepreneur's reasonable projections).

The expected value of the Company at the "exit," compared to the amount of capital the angel will need to invest, determines the percentage of equity the angel will demand in exchange for his or her investment. Investors may seek a 60% to 70% internal rate of

return (IRR), but because “stuff happens,” actual yield rates in angel investing are much lower (23% in 2005, 18.5% in 2004, and only 10.3% in 2003).¹

Angel Investors separate the “good deals” from the rest of the pack by looking at the following ten criteria (listed in order of importance, with the first being the most important). The ideal scenario for each item is described below.

1. Management.

A complete team, functional in each critical area, with a track record of success growing companies. Ideally, the team has worked together before, with success. The team has “fire in the belly” and most importantly, has a qualified CEO. If the team is not complete, the Founders must have the credibility to launch the Company and to attract world class talent to fill the gaps.

An outside Board of Advisors or a Board of Directors is a plus. How much money has management committed to the project? How essential is their particular expertise (and are they replaceable)? Any conflicts of interest? Are they able to communicate effectively? What is the “hubris factor” (is the entrepreneur “coachable” and is she willing to provide information to investors on a regular basis)?

The team is focused on a single project (or a small number of projects). Asking the team to work on several, separate, unrelated projects simultaneously is a red flag.

2. Compelling Idea.

The business is built on an idea that reflects a deep understanding of a very big problem, and solves that problem with a very elegant (efficient) solution. The problem creates enormous pain, and the Company’s solution increases revenues, reduces costs, increases speed, expands reach, eliminates inefficiency, increases effectiveness, etc. The Company forecasts high gross margins.

The Company’s product or service actually solves the problem.

Customers do not have to change their behavior in order to buy and use the Company’s product or service.

3. Proven Concept.

The Company has a prototype or a “proven concept” (i.e., the gizmo works!) that has shown revenue and can be scaled with additional funds. Investors would rather provide expansion capital, instead of development (R&D) capital.

The concept is protectible in some way (either through patent, copyright, trade secret, or a unique contractual relationship).

4. Market Size.

The “pain” that the Company’s product or service solves is felt by many, and the market is very big. Furthermore, the market will expand in the future at a very rapid rate. The Company will capture a meaningful percentage of a well defined,

¹ Center for Venture Research, The Angel Investor Market in 2005: The Angel Market Exhibits Modest Growth.

growing market (instead of a microscopic percentage of a huge, mature market). Annual revenue of \$30 million in five years is feasible.

The bigger the market, the better the return, but the smaller the market, the easier it is to define and address.

5. Competition.

“No competition” is a red flag: every company has competition (if it doesn’t, the problem the company is seeking to solve must not be very significant). The Company does have a few competitors (to validate that a real market exists).

However, the Company does have a sustainable, competitive advantage that can be clearly stated (and that is not simply the “first mover advantage”). A technology, key alliance or community that is not easily duplicated does create sustainable, competitive advantages.

The Company will survive, even if another Company with extremely deep pockets enters the marketplace.

6. Financial Projections.

The Company’s projections demonstrate that:

- it has (or is asking for) enough capital to reach milestones,
- the product or service is profitable,
- the time frame to reach profitability is acceptable,
- provisions have been made for future capital calls,
- the Investor will receive a return of 10x within five years (or, will yield 20% IRR for a “current pay” deal),
- the Company will have some liquidation value (equal to the amount of the Investors’ investment) if the idea is unsuccessful.

7. Exit.

The Company has identified several candidates (possibly including management) who can buy the business in five to seven years at a multiple of ten to twenty times today’s valuation.

Relying on an IPO for exit is a red flag in today’s economy.

8. Production.

A source for production has been lined up; that source agrees to produce at a cost which allows resales at a profit. Alternative sources are available. No special equipment is needed to produce the product.

9. Marketing Plan.

The Company has strategic alliances with others to assist with marketing (or with technology / R&D). The cost of reaching the potential customer is reasonable, as is the amount of time necessary to reach the target market.

10. Risks.

The Company has sufficiently addressed risks from government regulation, pending litigation, the need for future capital, etc.

Management has experience successfully overcoming risks.

You can help your client develop an *elevator pitch* (a two minute verbal summary of the client's Company, used to arouse the Investor's interest and get him to respond, "Tell me more"). In addition, you can help your client prepare an "*Executive Summary*" of the Company's business plan (a two to four page written summary that touches on each of the ten points above in more detail). See the attached "Executive Summary" template as a model.

C. Resources for Entrepreneurs

Much more information on writing business plans, preparing the "elevator pitch" and working with angels can be found at:

1. Angel Capital Association - www.angelcapitalassociation.com
2. Kaufman Foundation - www.eventuring.com
3. Inc. Magazine - www.inc.com/guides/write_biz_plan/20660.html
4. Start Up Nation - www.startupnation.com
5. Edward Lowe Foundation - www.edwardlowe.org
6. FasTrac Growth Venture, www.fasttrac.org
7. Ann Arbor IT Zone, www.annarboritzone.org
8. Automation Alley, www.automationalley.com

D. Where Can I Find Angels?

Angels are found the old fashioned way: networking! Because due diligence is time consuming and legal support is expensive for Angel Investors, many tend to travel in packs. The good news for entrepreneurs is that over the past several years, a number of Angel Investor networks have evolved to make the networking job of the entrepreneur easier. Networking opportunities exist at:

1. Plymouth Venture Partners (www.plymouthventurepartners.com)
2. Great Lakes Angels (www.glangels.org)
3. Grand Angels (www.grandangels.org)
4. Ann Arbor Angels (www.annarborangels.org)

III. What is a Typical Deal Structure for an Angel Investment?

A. The Competing Interests of the Investor and the Entrepreneur

Both the investor and the entrepreneur want the enterprise to grow dramatically, creating a great return for all involved. However, investors and entrepreneurs also have differing, sometimes conflicting interests:

1. **Investors.** Investors want to maximize their financial returns, but also wish to "protect the downside" as much as possible by being the "first money out."

Investors want to participate in the control of the Company (to some extent) and want some control over the “exit” (i.e., when they can “get out of the deal” by making their investment liquid).

2. **Entrepreneurs.** Entrepreneurs want to retain as much control as possible, want to avoid unnecessary taxes, and want to make sure that those founders who “go the distance” and stay with the Company are the ones who are most rewarded with equity.

B. How These Interests Result in a Deal Structure

1. **What Not to Do.** Issuing common stock to the Angel Investor, at the same time as the Founders receive equity (or additional equity) is a big mistake: this creates an income tax problem for the Founders, because the common equity they receive will be deemed to be “compensation income” (the value of which is set by the Angel Investor’s capital investment). See Internal Revenue Code Section 83(a). Furthermore, this structure does not give the Angel Investor priority protection (the “first money out” protection) he or she desires.

2. Two Typical Structures.

- **Convertible Debt.** A promissory note that converts into equity at a specified point in the future (usually on the next round of financing) and according to a negotiated formula, coupled with warrants (options to purchase equity at a specified price). In order to give the Angel Investor a reward for investing early, the debt usually converts at a discount to the price paid by the next round of financing, and/or the warrants are exercisable at a reduced price or nominal price.
- **Preferred Stock.** Preferred stock usually carries a set dividend, and enjoys a liquidation preference so if the Company is liquidated in an unsuccessful sale, the Angel Investor (as a preferred stockholder) gets paid first before the Founders receive anything. Preferred stock is convertible into equity according to a negotiated formula, giving the investors their “equity play” when the Company becomes successful.

With either convertible debt or preferred stock, the founder avoids the IRC section 83(a) tax problem; this is because, in either scenario, the investor receives his money out first in a liquidation, and the investor’s funds have not ballooned the value of the common stock held by the founders.

C. Other Agreements/Issues Covered in the Transaction Documents.

1. **Anti-Dilution.** As noted above, the investor’s convertible debt or preferred stock will be convertible into an agreed upon number of common shares. “Anti-dilution” provisions protect the investor in case the number of outstanding shares changes due to a stock split, stock dividend, etc. (that is, the percentage of equity the investor holds after conversion will be the same, as a result of these anti-dilution provisions, even if the number of outstanding shares has doubled, for example).

However, anti-dilution provisions also protect the investor in case additional equity is issued to future investors at a price below what the Angel Investor paid. In this situation, the investor can use one of two approaches: the “full ratchet anti-dilution” clause or the “weighted average anti-dilution” clause.

Under the “full ratchet” approach, the investor gets to convert his equity at the new (lower) price paid by the later investor *no matter how much or how little the later investor invested*. Under the “weighted average” approach, a subsequent round of financing at a lower price – if the subsequent round is relatively small – will not significantly reduce the Angel Investor’s conversion formula (this is because the new conversion price is the weighted average of the Angel Investor’s price and the later “down round”). Avoid the full ratchet dilution!

2. **Registration Rights.** This agreement is one of the two popular ways that investor controls the “exit” (the other popular way being “put rights,” discussed below). In this agreement, the Company agrees to effect a registration of the Company’s stock under federal securities law (The Securities Act of 1933), and applicable State Securities laws (essentially a “going public” transaction).

If the Company permits the investor to demand such a registration when the Company had no intentions of otherwise doing so, it is called a “demand registration”; where the Company is doing a registration anyway and lets the investor piggyback on that registration it is, not surprisingly, called a “piggyback registration.”

In the current environment, IPO’s as an exit strategy are rare (selling the Company to a larger, publicly traded company already in the business is a more likely exit scenario); furthermore, before a company is ready for an IPO, it has usually secured several additional rounds of financing beyond the angel round, and each of those investors will insist upon their own registration rights agreements (to which the angel’s agreement must conform). Accordingly, at the angel stage, the Registration Rights Agreement is nice to have, but usually is not hotly negotiated.

Issues to consider, however, are: whether the angel will even have demand registration rights, how soon the angel can demand a registration, the minimum amount of stock the angel must sell in the registered offering in order for it to make sense to have the Company undergo the expense and bother of filing a registration statement, and whether the Company can defer a demand for registration if the business climate is not right, etc.

3. **Restrictions on Stock Transfer.** Because the Angel Investor is betting on the Founder to hit the homerun, and because the Founder’s primary motivation is the appreciation in his or her equity, the angel wants to make sure the Founder stays in the game until the last inning. Thus, angels typically restrict the ability of the Founders to transfer their stock to third parties.
4. **Co-Sale Rights (Tag-Along or Drag-Along).** From the angel’s perspective, “co-sale rights” means the ability of the Angel Investor to “tag-along” and include his or her shares in any sale made by the Founder of the Founder’s shares (such tag-along to be on a prorata basis) at the same price and terms as paid to the Founder. This prevents the Founder from bailing out and leaving the angel behind.

Conversely, the angel would also like to have “drag-along rights” such that if the angel finds a potential buyer for the angel’s shares, the angel can force the Founder to sell their shares as well to the same third party on the same price and terms as paid to the Angel. The benefit here to the angel is, of course, most business purchasers want to buy 100% of the equity of the business, not just a majority stake

(and definitely not a minority stake, if indeed the angel only has a minority interest in the Company).

5. **Put Rights.** If the Company is successful and experiences several rounds of financing, concluding with a public offering or merger/sale, the Angel Investor will “exit” (realize liquidity for his or her investment) along with everyone else in the Company. But if the Company stalls, the “put right” is the angel’s ability to get out of the Company (or, force a liquidation of the Company, with the distribution of proceeds prorata to everyone). A “put right” is the angel’s right to force the Company to repurchase the angel’s equity in the Company after a certain date at a certain price. The price can be determined by appraisal, or by a formula (for example, the angel’s investment plus a cumulative annual rate of return of X percent). On occasion, the put purchase price (an obligation of the Company) is also personally guaranteed by the Founders (but this is not the norm).
6. **Board Representation.** The Angel Investor will want to know what is going on with the Company, checking in on a quarterly or monthly basis and sometimes even more frequently. The Angel Investor will typically want a seat on the Board of Directors, so that the angel will be entitled to receive all inside information on the Company available to other Board members, as well as a vote (although usually not majority control, unless bad things are happening) on the Board.

In some cases, the Founder can get away with giving the Angel Investor mere “observer rights” (i.e., the right to sit in on Board meetings, but not to participate or vote). *However, because the Founder should be choosing an Angel Investor who can provide “value added capital” (i.e., sage advice as well as money), the Founder usually does not object to giving the investor a Board seat (and in fact encourages it).* Investors often will specify a defined suite of monthly financial reporting statements that the Company must generate and give to the investor.

7. **Vesting of Founder’s Equity (Section 83(b) Election).** Investors sometimes insist that the Founder’s “earn” their equity by continuing to stay actively involved in the day to day management of the Company; in other words, a Founder who ceases his or her active involvement “early” (whether through a voluntary quit, or involuntary termination) will lose all or a portion of his or her equity in the Company -- the Founder’s equity does not “vest” until he or she remains employed for a certain period of time.

Where the Founder has been issued equity in the Company in exchange for rendering future services, the Internal Revenue Code provides that such equity is taxable income to the Founder (taxed at ordinary income, salary rates). IRC Section 83(a). However, where the equity is subject to a “substantial risk of forfeiture” (in other words, where the Founder stands to lose that equity if he or she fails to perform), the award of equity does not become a taxable event until the substantial risk of forfeiture lapses (i.e., until the equity vests). But, the bad news for the Founder is that in such a scenario, the vested equity will be deemed to be compensation *in an amount equal to its fair market value at the time the risk of forfeiture lapses*. If all goes according to the business plan, this amount could be very substantial.

Founders in this scenario have the opportunity to make a “Section 83(b) election”; in short, the Founder elects to report the award of equity as taxable income

immediately upon the award, even though it is still subject to a substantial risk of forfeiture. Usually, at the time the equity is awarded, its value is relatively low. If the Founder makes the 83(b) election, he or she reports taxable income at the “low” value; later, when the shares vest - and are much more valuable - the Founder does not report any taxable income. Later, when the shares are actually sold, she reports taxable income at capital gain rates.

In most cases, it makes sense for the Founder to make the Section 83(b) election. However, if all does not go according to plan and the Company fails, the Founder who makes the 83(b) election will end up paying income tax on an award of restricted stock which is ultimately valueless. Life is full of trade offs!

In order to make the Section 83(b) election, the Founder must file a Section 83(b) Election Statement with the IRS (at the IRS office where the Founder regularly files his tax returns) within 30 days of receiving the grant of equity. The Election Statement must be sent to the Company and also attached to the Founder’s income tax return for the year of transfer. The statement must include the taxpayer’s name, address and tax identification number, a description of the property which is the subject of the election, the date of the transfer, the nature of the restrictions on the equity, the fair market value of the equity, the amount paid (if any) for the equity, and a statement that a copy of the election has been filed with the employer.

IV. What Legal Services/Advice Can You Offer Your Client to Help Them Attract Angel Funding?

A. Choice of Entity

There exists a frothy debate among scholars and practitioners whether the venture startup should be structured as an LLC, or as a C corporation (co-partnerships are out because they obviously provide no liability protection to the owners, and limited partnerships usually are disfavored because of the need for at least one full-liability general partner; S corporations won’t work, because the moment an Angel Investor invests with preferred equity – or even with convertible debt that converts into equity – one risks violating the “second class of stock” restriction on S corporations).

The best recent article on the subject can be found at: Goldberg, *Choice of Entity For A Venture Capital Startup: The Myth Of Incorporation*, 55 *The Tax Lawyer* 923 (Summer, 2002).

The Author’s preference is to form the entity as a Michigan LLC (due to the ease and speed of formation, plus the ability of the Founders to obtain deductions for early losses against their other personal income), followed by incorporation of the LLC, either in Michigan or in Delaware prior to the Angel (or even venture capital) investment.

There may be no one “right” answer, but in the money hunt, at least having a well reasoned explanation for having the entity you do will be adequate for the Angel Investor.

Recent amendments to Delaware’s Corporate General Law permit a non-Delaware LLC (such as a Michigan LLC) to convert into a Delaware corporation in one-step. Title 8, DCGL Section 265. Previously, a Michigan LLC wishing to convert into a Delaware Corporation first had to merge into a Delaware LLC, and the Delaware LLC had to be converted into a Delaware corporation. The two step process often triggered “change in

control” clauses in the LLC’s agreements with third parties, and could also trigger franchise tax issues.

B. Founders Agreement

Here’s where we get to herd the cats into the wheelbarrow!

If the new enterprise has two or more Founders, it is in the best interest of EACH of them, that they ALL agree to a Founders Agreement.

This doesn’t have to be an extensive document, and often the conversation that precedes drafting the Agreement is as valuable as the Agreement itself. The key is to avoid a scenario where each Founder has poured substantial time, effort, money and intellectual capital into the enterprise, only to find out that a key Founder now “recalls the deal differently” (e.g., “I thought that I was going to get a controlling interest.”)

The Founders Agreement should cover:

- Goals for the Company
- all IP is owned by the Company
- how the Company is to be owned (what % is held by each Founder)
- if there are two equal Founders, how they will resolve deadlocks between them
- who will manage the Company, and how much time each Founder is expected to devote to the Company
- the Founders should not be able to have a competing interest or job (ie, a non-compete for Founders), or if they can compete, the parameters under which that is permitted
- the Founder’s interests in the Company should not be transferable without the consent of the others
- a vesting schedule for each Founder’s equity
- a provision that the Founders Agreement (as well as other key agreements) can be amended with the consent of two-thirds of the Founders

See the Appendix for a sample Founders Agreement.

C. Clean Up the Cap Table

The “cap table” (short for capitalization table) sets forth in a single chart the identity of each equity owner in the business (and each holder of “equity equivalents” like convertible notes, warrants, stock options, employee incentive stock options, etc.). Too often, the Company has made promises of actual (or contingent) equity to a variety of people, on a variety of different deal terms, leaving the current status of *who owns the Company* murky. This complicates the Angel’s investment for obvious reasons (if the Founder isn’t sure who owns the Company, how can he or she promise that the Angel Investor will receive a specified percentage?).

As a related topic, the Company should have no unusual prior history (for instance, it should not have engaged in a prior business, and should not be a “public shell”). All of the equity interests should be held by the Founders and members of management (and perhaps a small group of people who have made actual investments in the Company), and no more. The articles/bylaws/operating agreement/meeting minutes should be clear, complete and up to date with no unusual provisions. There should be no “preemptive rights” in favor of anyone. All prior issuance of equity should be clearly documented and compliant with applicable Securities laws.

D. Securities Law Compliance

For the early stage company, “securities law compliance” means two things: making sure that every time equity is issued (and every time equity has been issued) (a) the issuance fits within an *exemption from registration* (both at the federal and the state level); and, (b) the investor has received full *disclosure of all material information*.

Exemption from Registration. The most popular exemption from registration under the federal Securities Act of 1933 is Regulation D. At the state level, Michigan’s Section 402(b) (9) and/or the “Uniform Limited Offering Exemption” (or ULOE) provide safe harbor exemptions as well.

If securities are issued without an available exemption, the security purchaser (investor) will be able to rescind the transaction at any time within one year (federal law) or two years (Michigan law), recover their purchase price, plus interest at the rate of 6%, plus attorney’s fees; officers, directors and controlling persons may also be liable.

In light of these remedies, many Founders rely on the “good deal exemption” – the belief that if their company is successful, no one will ever want their money back; unfortunately, relying on the “good deal exemption” can make the Founder an insurer of a good deal, and at a minimum will complicate the fundraising process (because angels and later investors do not want their investment money used to buy off an unhappy earlier investor.)

Regulation D. Regulation D offers three types of exemptions, depending on the size of the offering.

- For offerings of \$1 million or less, without regard to the number of purchasers or size of any one purchaser. Rule 504.
- For offerings not exceeding \$5 million, a sale to not more than 35 non-accredited investors (and an unlimited number of accredited investors). Rule 505.
- For offerings over \$5 million, sales to no more than 35 non-accredited investors (and an unlimited number of accredited investors), only if each non-accredited investor is sophisticated. Rule 506.

Regardless of which of these three exemptions applies, the Company must also comply with the following additional rules:

- **Integration.** For purposes of computing the size of the offering, the Company must include sales of equity both six months before and six months after the offering.
- **Information.** For sales under Rule 505 or Rule 506 to non-accredited investors, each investor must obtain a specified package of information (set forth in Rule 502).

- **No Solicitation.** Securities cannot be sold through the use of general solicitation or general advertising. (In other words, each purchaser must have some sort of prior business relationship with the Company or with an intermediary that the Company is using.)
- **Resale Restrictions.** Investors who purchase exempt stock under Regulation D cannot resell their shares unless their purchaser qualifies under Regulation D as well (or some other exemption).

“Accredited Investors” include: (a) directors, executive officers or general partners of the Company that is issuing the securities (thus, the Founders themselves are “accredited investors” if they are key managers); (b) individuals whose net worth (or joint net worth with their spouse) exceeds \$1 million; or, (c) individuals who had individual incomes of at least \$200,000 in each of the two most recent years (or joint income with their spouse in excess of \$300,000 in each of those two years) and who have a reasonable expectation of earning the same amount in the current year. There are other “accredited investors” under Regulation D (like banks, charities with assets over \$5 million, etc.), but in the Author’s experience, encountering these types of accredited investors is rare.

In short, the safe course for the Founders in compliance with the federal securities law exemptions is to *sell to wealthy individuals*, and *avoid general advertising or solicitation* to reach them.

This is a broad overview of Regulation D. Other specific rules pertain, and the reader is advised to peruse the entirety of the Rule for this detail. See 17 CFR 230.501-505.

Michigan Exemptions. Like Regulation D, Michigan securities law will exempt certain offerings, provided the terms comply with a set of rules that is similar to (but not identical to) Regulation D. For example, under the Michigan exemptions (like Reg D), general advertisements and general solicitations are prohibited, the securities purchased are “restricted” and the number of purchasers is limited (unless the purchaser meets certain high net worth requirements). Unlike Regulation D, Michigan prohibits the payment of commissions to intermediaries in connection with the raising of capital, unless the intermediary is a registered broker dealer under State and Federal Securities law.

- **Section 402(b) (9).** Under this section of the Michigan Securities Act, there are five separate exemptions:
 1. Up to 10 sales of securities in any 12 month period to: persons active in management, attorneys or accountants for the Company, and family members.
 2. An additional 15 sales to persons whose principal business is the same as the Company and who are qualified by previous experience to evaluate the risks of the investment.
 3. Sales of up to 25 persons in any 12 month period if purchasers receive a disclosure document 48 hours prior to the sale which meets the content requirements of the Act.
 4. A sale to up to 35 different investors in any 12 month period if each investor receives a disclosure document that has been approved by the Michigan Securities Administrator.

5. Sales to purchasers (without limit as to number) if the purchaser has a net worth in excess of \$1 million or an after tax net income of over \$100,000 (if the investor is a business it must also be investing less than 10% of its assets in the Company; if the investor is individual, it must invest at least \$50,000 in the Company and have knowledge and experience such that he or she is capable of evaluating the merits and risks of the investment).
- **ULOE.** Michigan (like many other states) offers a Uniform Limited Offering Exemption as well (in general, an offering that is exempt under Rule 505 or 506 of Regulation D, will be likewise exempt in Michigan under ULOE) (note: offerings exempt under Regulation D Rule 504 do not also qualify under ULOE). In addition, if relying on the ULOE exemption, the Company must file a Form D with the State of Michigan and, if sales are made to non-accredited investors, the Company must reasonably believe that the investment is suitable for the investor, or that the investor has sufficient business and financial experience to evaluate the risks and merits of the investment.

A detailed description of the Michigan Securities exemptions can be found in Business Guide to Selling Securities in Michigan, published by the Michigan Department of Consumer and Industry Services; available at www.michigan.gov/documents/cis_ofis_guide_25011_7.pdf.

E. Intellectual Property Matters

Although a full evaluation of the Company's intellectual property portfolio is beyond the scope of this seminar, the two major focus areas for Company counsel are: *first*, does the Company own or control its existing technology, and *second* will the Company own or control future developments?

As to the first issue, you should confirm that the team of Founders includes all of the inventors and/or developers of the Company's intellectual property (and they developed that technology while working for the Company), and none of the Founders have signed any agreements with any prior employers or other third parties that will limit the Company's use of its technology (for example, there are no noncompetes with prior employers, no invention agreements or license agreements with third parties, etc.). Finally, if the Company's IP has been developed through university research or government sponsored research, make sure the Company has an adequate license to use of that technology.

As for the second inquiry, each Founder should sign a new Invention/Assignment/Nondisclosure/Confidentiality Agreement with the Company. See the Appendix for an example of such a form.

F. Due Diligence Lite

Angel Investors will perform typically about 40 hours of "business due diligence" and in addition some level of "legal due diligence." The Appendix contains comprehensive checklists for both business due diligence and legal due diligence. But often, the legal due diligence is more like "due diligence lite," a search for major issues and roadblocks only. As counsel for the Company, to the extent you have prescreened the Company under a "due diligence lite" examination, the angel's review will proceed that much more smoothly.

Due diligence lite would include a review of:

1. Organizational documents (articles, bylaws, operating agreements, minutes, etc.);
2. Stock transfer ledger/capitalization table;
3. Material agreements (license agreements - both inbound and outbound, employment agreements, nondisclosure agreements, consulting agreements, noncompete agreements, and agreements with material suppliers or customers);
4. Patents and patent applications;
5. Any pending or threatened litigation (there shouldn't be any!);
6. Stock Option Plans; and
7. Any Shareholder Agreements or Founder Agreements.