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CORPORATE & BUSINESS SERVICES

LEGAL ISSUES IN A START-UP. PART IV - RAISING CAPITAL

The series of several articles intend to highlight critical legal and business issues for start-ups. Part I discussed intellectual property law and the methods available to entrepreneurs to protect their company's primary assets. Considering such factors as personal liability, tax implications, and ownership flexibility, Part II examines choice of entity alternatives for a start-up discusses the factors to consider in deciding where to organize the start-up company. Part III highlights employment law issues and related potential liability of officers and directors. Part IV examines the critically important process of raising capital for a start-up company. Part V addresses the securities regulation and the sale of equity interests in the business. In Part VI, this article reviews typical exit strategies for start-up companies including initial public offerings (IPOs), sales and mergers, and bankruptcies.

1. Capital Structure

Creating a successful business depends in many cases on whether the entity is adequately capitalized. Expenses quickly add up, and a business that cannot manage its cash flow will not survive. From the earliest stages, entrepreneurs must determine the financial structure of the business. Financing alternatives include two general financing techniques - debt or equity financing. Debt financing is defined as borrowing money with a final obligation to repay the debt. Equity financing is defined as selling investors an opportunity to own part of the company. Typically, however, an early stage entrepreneur's decision is limited to raising money through equity financing.

To finance a start-up business, entrepreneurs can theoretically decide to either borrow money or sell ownership interests to investors. Entrepreneurs must determine their best financial strategy based on long-term needs, broken down into stages, and the best ways and sources for getting funding. No one method is inherently better than the other. Sometimes favourable financing can be obtained through borrowing, although generally selling equity in a company may be the only method available to finance a start-up business. Generally, raising debt capital is available only to companies with earnings and assets. Entrepreneurs should consider factors such as the type of assets held by the business--tangible or intangible--and the climate for investors in deciding whether the entity is a candidate for debt or equity.

Moreover, because most start-up technology companies generate no working capital to support repayment of a loan, debt financing is more difficult unless the company has already raised significant equity capital. Generally, banks do not finance start-ups because of their speculative nature, and the lack of tangible assets and earnings in the short term. For many of the above reasons, banks are an unlikely source of financing for start-up companies.

When an entrepreneur decides to sell ownership interests in the business, this activity is referred to as equity financing. Broadly speaking, entrepreneurs can sell two types of equity securities in a corporation: common stock and preferred stock. Common stockholders usually have the right to participate in management control by choosing the directors and by voting on fundamental changes. Also, common stockholders have the right to receive legally declared dividends and to share in the distribution of net assets if the business is dissolved. Common stockholders directly participate in the ups and downs of the business. Although common stockholders have a claim to the net assets of the business, if the business is dissolved, that right is subordinate to the business's debtors and the preferred stockholders.

Preferred stock can have characteristics of both equity and debt. Generally, preferred stock has preference over the common stockholders in the payment of dividends and also has preference in liquidation. Not all preferred stock is the same; businesses can add many different provisions to a preferred stock offering. Different rounds of financing will normally contain different rights and preferences in the company's preferred stock.

One feature of preferred stock is the grant of cumulative or non-cumulative dividends. Cumulative rights to dividends means that if the business misses dividend payments to the preferred stockholders, the preferred stockholder has the right to receive back (missed) dividends plus the current dividend before any dividends are paid to the common stockholders. Non-cumulative preferred stock means that the preferred stockholder loses dividend payments for any year in which no dividends were paid. Preferred stock may be structured to be redeemable by the business. Where redemption is included as a right of the holders of preferred stock, the business must buy back the preferred stock from the investor for a specified price at a specified time at the request of the investor. Redemption rights are usually triggered upon the expiration of a five to seven year period following the date of investment. Similarly, preferred stock normally includes demand registration rights. Preferred stock may be converted into common stock at a predetermined ratio. Preferred stock typically includes voting rights. Through these voting rights, investors are treated similarly to the holders of common stock in that they have a direct vote in the election of directors of a company and in all fundamental changes. Increased voting rights and increased investor control of the board of directors may be tied to the failure by the company to achieve certain performance milestones.

With respect to its liquidation rights, preferred stock may be participating preferred or non-participating preferred. At the time of a sale or liquidation of a company, participating preferred shareholders receive their liquidation preference first, and in addition, they then participate in a stated ratio with common stockholders in dividing up any remaining assets. By contrast, non-participating preferred shares do not participate beyond their liquidation preference.

2. Raising Capital

The first place many entrepreneurs get money from is themselves. Entrepreneurs must be personally and financially committed to the business. Many entrepreneurs mortgage their homes, raid Access to these sources of capital may be critical to a start-up business, but they come at a high emotional and financial cost.

After entrepreneurs have exhausted their personal financial resources, they usually turn to their friends and family for financing assistance. It should be noted, however, that institutional investors are hesitant to fund companies owned by a large number of individual investors or companies controlled by family members. In addition, a company having been funded by family and friends that ultimately fails can be financially catastrophic for the family and friends. The entrepreneur must disclose that the business may fail, and if it does (and the probability of that is high), the friends and family will lose their money invested. Failure invariably

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strains relationships. By adding multiple investors, an entrepreneur adds complexity, such as holding management meetings and potentially losing control of the business. Often the founders, together with family and friends, become the only investors in the "seed round" of financing. The proceeds of a seed round may be used for the company's preliminary research and development and marketing efforts. Even with significant seed funding, successful companies normally require several additional rounds of financing.

"Angels" provide entrepreneurs with another (or frequently a second) financing option. Angels are typically successful business people with a high net worth that invest in and often advise start-up companies. Angels frequently provide access to capital as well as sound business advice. Angels, as their nomenclature indicates, have been saviours to start-ups, historically investing as much as $50-100 billion annually. The amount of capital invested and the depth of involvement in the company vary significantly based upon the individual circumstances of the angel.

Following early stage financings, entrepreneurs often need additional growth capital. Creating a solid business plan is a key to attracting venture capitalists (VCs) to fund a company's growth. Venture capital is a substantial equity investment in a non-public enterprise that does not involve active control of the firm. Virtually all venture capitalists focus intensely on the experience and maturity of the management team of an entrepreneurial company. Individual partners within a venture capital firm frequently specialize in a targeted business market, such as biotech or software. Similar to their prominent role in computer technology start-ups, VCs are arguably the single most important form of financing in the biotech industry as well. Attracting a VC with a reputation for success in many cases facilitates the operation and growth of a business. It is the reputation and contacts of the VC that impact customer decisions, supplier relationships, banking, legal and accounting relationships, as well as the recruitment of key employees.

VCs differ from angels in that they typically invest other investors' capital in start-ups. Generally, VCs are organized as limited partnerships. Investment risk is reduced for institutional investors by investing in multiple funds, in which money is pooled from wealthy individuals and institutions and then invested in various promising, young start-ups. VCs invest to make significant returns for their limited partners. In 2011 in Canada, venture firms raised $20.6 billion from pension funds, endowments and wealthy individuals, which is down significantly from the record-breaking $54.6 billion raised in 2000. Company managers live in a constant pressure cooker, always evaluating any viable "exit strategy" in order to provide liquidity to a VC for taking the investment risk. During the 1980s VCs enjoyed an average long-term return on investment (ROI) of twenty-two percent per year while the ROI for the Standard & Poor's index of public companies was fourteen percent. In the boom days of 2000, some funds returned an amazing seventy-five to ninety percent. While many of the boom time start-ups will fail, VCs balance this certainty with other companies in the portfolio that become "Wild Ones."

Despite the steep turn around in ROI, VCs continue to make substantial investments in start-up companies. For founders, relinquishing more ownership is inevitable as VC's value start-ups in a manner that mirrors the downturn in public markets. Investors receive preferred stock that converts into a larger percentage of the company. If the investment is made after poor performance, the preferred stock may represent virtually all of the equity of the company. Even during the boom investment years, a typical start-up required several financing rounds before a successful exit. As a result, founders' percentage of ownership will almost always decline significantly by the time of exit.

Dilution of equity value is a concern for today's seed round investors. If a company is not able to achieve demonstrable milestones with seed capital, the company's value drops precipitously in later rounds. As more shares are issued, investors in the earlier round are diluted in their percentage ownership of the start-up. VC's attempt to reduce the impact of subsequent dilutive events with anti-dilution provisions that adjust the diluted investors' conversion ratio. This adjustment attempts to stabilize their percentage ownership despite the dilutive round.

In many cases, VCs are directly involved with the business's day-to-day operation. While VCs may require seats on the board of directors, they always require significant rights to be informed on a current basis of all material financial and strategic events of a company. Requests for information begin during the VC's due diligence, and such information assists in determining conformity of the target investment with the VC's investment criteria, such as the size of the target's potential market and specific projected growth rates.

Financing documents are critical to the operation of a start-up. The covenants and restrictions in an agreement between the start-up and the investors determine control of the company, conversion rights, antidilution terms, registration rights, voting rights, the board of directors, vesting rights of options granted to employees, and closing expenses. Therefore, an entrepreneur should hire experienced advisers to assist the entrepreneur in structuring restrictions and obtaining balanced transaction documents. The formal investment process begins when the entrepreneur and investor have reached mutually acceptable terms. The terms are set forth in a detailed "term sheet."

An initial public offering (IPO) is a significant step in the maturation of a business from small start-up stage to successful operating company. Traditionally, a start-up company will be in business for a number of years and complete several venture capital rounds before going public. A few years ago, entrepreneurs quickly gained access to the public markets. More recently, the window on IPOs has been closed and the market for mergers depressed. Venture investors are directly impacted by the IPO and merger markets; as a result, in the third quarter of 2011, venture investment fell to $0.5 billion compared with the $2.5 billion invested in Canada during the first quarter of 2000.

This investment downturn has a direct and significant affect on the VC's. In 2009, 133 VC firms employed more than 4,300 professionals. Those numbers had doubled since 2000. However, in the last two years, VC professionals have been laid off or left for more secure corporate positions. Many VC firms have disbanded or abandoned plans to raise capital for additional venture funds. As a result, with access to capital drying up, virtually all start-ups have scaled back their enterprises considerably.

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