



STRUCTURING INVESTMENTS IN STARTUPS

November 7, 2018

Amit Singh

Shareholder

Stradling Yocca Carlson & Rauth, P.C.

858.926.3012 | asingh@sycr.com

Stradling
Attorneys at Law

Amit Singh, Esq.

Corporate Shareholder

Amit is a shareholder in Stradling's corporate and securities law and technology transactions practices.

Amit is a corporate governance and business transactions expert, with over 20 years' experience in venture capital and private equity transactions, mergers and acquisitions, joint ventures, technology transactions and general corporate law.

Amit counsels companies and investors in a broad range of industries, including life sciences, software, hardware, communications and networking, internet, manufacturing and distribution and medical devices.

Amit earned an LL.M. (Corporate Law) from New York University School of Law in 1999 and a J.D. in 1998 from University of California, Hastings College of the Law.

He is a member of the State Bar of California and the State Bar of New York.



Office: San Diego
asingh@sycr.com
(858) 926-3012

EDUCATION

New York University School of Law,
LL.M. (Corporate Law) (1999)

University of California, Hastings
College of Law, J.D. (1998)

PRACTICE AREAS

Corporate Law
Private Equity
Startups and Emerging Companies
Venture Capital
Mergers and Acquisitions
Technology Transactions

GETTING STARTED

- Investor Deck
 - Barriers to Entry
 - Value Proposition
 - Size of Opportunity
 - Size
 - Growth Rate
 - Management
 - Amount Needed and Use of Proceeds
 - Tranched - Based Financing

INVESTOR TARGETS

- Angel/Incubator
 - Track Record
 - Mentoring Capability – How much time is available for the company?
- Venture Capital Funds
 - Industry Specialization
 - State of Company’s Development
 - Size of Investment Preferences
 - Compatibility of Personalities
 - Active vs. Passive Management Role
 - Syndication Ties to other Venture Funds for Additional Rounds of Financing
- Corporate/Strategic Investors
 - Added Value
 - Value of Logo Behind Startup
 - Choosing Your Partners/Also Choosing Your Enemies

GOALS

- Investor Goals
 - Downside Protection
 - Upside Protection
 - VCs - Exit Within 5 Years
 - Corporate/Strategic – Access to IP/Markets
- Founders' Goals
 - Maintain Control
 - Capture Upside of their Efforts
 - Create Something
 - Make a Living and Have Long-Term Career

Common Investment Structures

- Common Stock
- Series A Preferred Stock
- Series Seed Preferred Stock
- Convertible Notes
- SAFEs

Common Stock

- Equity that receives all proceeds after paying debts and Preferred Stock
- No Liquidation Preference
- No Protective Provisions
- Simple
- Negotiate Valuation
 - Sets option price (cannot issue options with a lower strike price)
 - Could result in tax to founders if issued concurrently
 - No anti-dilution
- Eligible for QSBS Treatment
 - No federal tax if company has less than \$50M in assets and is an operating company
 - Exclude greater of \$10M or 10x investment if held for 5 years

Series A Preferred Stock

- Converts into Common Stock
- Dividend Preference
 - Cumulative vs Non-cumulative
- Liquidation Preference
 - Participating vs Non-participating
 - Cap vs no cap on participation right

Series A Preferred Stock *(Cont'd)*

- 1x Liquidation Preference Example
 - VC invests \$1M for 20% of Company, and receives a 1x liquidation preference
 - Post Money Valuation = \$5M
 - Sell Company for \$20M
 - Non-Participating Preferred
 - VC receives either
 - Investment Back = \$1M; or
 - **20% of \$20M = \$4M**

Series A Preferred Stock *(Cont'd)*

- Participating Preferred
 - VC receives \$1M Investment Back
 - Then, VC receives 20% of remaining \$19M = \$3.8M
- Results – VC Owns 20% of Company Receives:
 - Non-Participating Preferred – \$4M (20% of Proceeds)
 - Participating Preferred - \$4.8M (24% of Proceeds)

Series A Preferred Stock *(Cont'd)*

- Valuation Issues – Determining Share Price
 - Pre-Money Valuation/Fully-Diluted Shares = Share Price
 - \$10M Pre-Money Valuation (Company value b/f investment)
 - 5M Common Shares Outstanding
 - 2.5M Options Outstanding
 - 2.5M Options Reserved
 - Price Per Share = $\$10\text{M}/10\text{M}=\1
 - Option Pool Size (including in the fully-diluted shares)
 - Use Hiring Plan to Justify Size

Series A Preferred Stock *(Cont'd)*

- Price Based Anti-dilution Protection
 - Full Ratchet
 - Weighted Average
 - Narrow Based (typically includes only common stock and common stock issuable on conversion in the denominator) – Investor favorable and atypical
 - Broad Based (typically also includes shares issuable upon exercise of options, warrants, etc. in the denominator) – Company favorable and more typical
 - Standard Carve-Outs

Series A Preferred Stock *(Cont'd)*

- Detailed Representations and Warranties
- Protective Provisions
- Preemptive Rights
 - Standard Carve-Outs
- Redemption Rights *(Rarely Granted)*
- Drag-Along Rights

Series A Preferred Stock *(Cont'd)*

- Rights of First Refusal
- Co-Sale Rights
- Registration Rights *(Rarely Used)*
 - Demand
 - Piggyback
 - S-3
- Information Rights
 - Inspection Rights
 - Financial Information
 - Management Rights Letter

Series A Preferred Stock *(Cont'd)*

- Board Representation
 - Committees
 - Observers
- Because of Superior Rights - Less effect on option price
- Eligible for QSBS

Series Seed Preferred Stock

- Non-participating
- Limited (But Effective) Protective Provisions
- No Anti-dilution Protection
- Limited Representations and Warranties
- Most Favoured Nations Clause
 - Get any favorable terms offered to others
- Eligible for QSBS

Series Seed Preferred Stock (Cont'd)

- Board Representation
- Drag-Along

Convertible Notes

- Principal Amount Due on Maturity Date
- Interest Accrues
- Converts into Equity
 - Exit Event
 - Qualified Financing
- Valuation Deferred
 - Cap
 - Discount

Convertible Notes *(Cont'd)*

- 20% Discount (No Cap) Example
 - Investor invests \$100K at early stage
 - Series A Financing at \$100M valuation
 - Loan Converts at \$80M
 - Investor gets .125% of equity ($\$100\text{K}/\80M) worth about \$125K (.125% of \$100M)
- \$5M Cap (in same example)
 - Investor gets 2% of equity ($\$100\text{K}/\5M) worth almost \$2M (2% of \$100M)

Convertible Notes *(Cont'd)*

- Protections?
 - No fiduciary duties owed to debt holders outside insolvency
 - Only protections are negotiated negative covenants
- Capital Gains Holding Period likely starts on note issuance
- Stock received on conversion eligible for QSBS

Simple Agreement for Future Equity (SAFE)

- Similar to Convertible Note
 - Converts into a later round
 - Caps
 - Discounts
 - Liquidity Event – receive
 - Investment or
 - Shares of Common Stock (using cap/discount)
 - No Maturity Date
 - No Interest
 - Capital Gains Holding Period may not start until conversion to equity

Other Issues

- Founder Vesting
 - Vesting Credit
 - Acceleration
 - Change of Control (Single vs. Double-Trigger)
 - Termination without Cause/For Good Reason

Summary

- Series Seed vs Series A Preferred Stock
 - Simpler
 - No Anti-dilution Protection
 - Limited Representations and Warranties
 - Most Favored Nations
- SAFEs vs Convertible Notes
 - Simpler
 - No maturity date or interest rate
 - May be deemed an option - Capital Gains Holding Period may not start until conversion