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…So You Want to Grow Your Business?

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Presenter Background

Matthew Engle
Shareholder at Gallagher & Kennedy

- Practices corporate, M&A, securities, and general business law.
- Represents companies at all stages, from pre-formation concept-stage to large public companies.
- Participated in drafting Arizona’s LLC law.
- Co-author of *Arizona LLC: Forms and Practice Manual* (published by Data Trace Publishing).

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Today's Presentation

A. Best practices & tips for your startup.

B. Capital raising basics.

C. Steps to prepare to raise capital through equity offerings.

A. BEST PRACTICES & TIPS FOR YOUR STARTUP

Best to get things right from the start… It's much more costly to try and fix things later.

1. Structure Your Company Clearly From the Start

- What is the deal?
- Who is involved?
- Who is responsible for what?
  - Define areas of responsibility.
  - Founders sometimes take an “everyone does everything” approach. Can lead to conflicts later.
- Who is getting paid what?

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2. Complete Your Organizational Documents

It's easier and cheaper to do things correctly from the start than to clean them up later.

- LLCs:
  - Articles of Organization.
  - Operating Agreement.
  - Buy-Sell Agreement.
    - Note: new LLC Act became effective Sept. 1, 2019 for new LLCs and Sept. 1, 2020 for all LLCs.
- Corporations:
  - Articles of Incorporation.
  - Bylaws.
  - Shareholders Agreement.
- Maintain minutes of board, shareholders, and member meetings and consents from the start.

3. Properly Draft & Execute Agreements

- Use correct party names.
  - Does the company you are contracting with actually exist?
- Substance first:
  - Who is doing what?
  - Length of agreement?
  - Payment terms?
- Other common clauses:
  - Indemnification.
  - Dispute resolution (mediation, arbitration…).

3. Properly Draft & Execute Agreements (continued)

- Don’t sign company agreements in individual capacity.
  - Always sign in capacity of an officer or other authorized person of the entity.
  - Use proper signature block.
  - Remember – directors usually should <u>not</u> sign agreements.

4. Protect Your Intellectual Property

- Patents, copyrights, trademarks, and trade secrets.
- IP being contributed by founders for equity?
  - Get assignments of IP.
- Employees and independent contractors:
  - IP created and developed on company time using company resources.
  - Have new hires sign a “present assignment” that assigns everything they invent to the company.
  - “Work for hire” language for contractors.

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4. Protect Your Intellectual Property (continued)

- Trade Secrets:
  - Unlike patents, these are protected without registration.
    - Example: formula for Coca-Cola®.
  - Take steps to protect them.
  - Confidentiality agreements with third parties; company policies to ensure they stay secret.
- Joint venture and collaborative agreements:
  - Set forth rules related to IP ownership developed in the collaboration.

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5. Remember Securities Laws

- Any time you seek to raise money, securities laws are involved.
  - Complex rules – both federal and state.
    - Taking money = a security.
    - Securities are either registered, exempt, or illegal.
  - Regulation D – Common private placement exemption.
  - Seek attorney advice before soliciting investors!
    - Yes, even from friends and family….

6. End of Year Considerations

- Take stock of where things stand.
- Prepare financials.
- Double check:
  - Did the company's board, shareholders, or members meet?
  - Any issues to ratify?
  - Do you have minutes or consents?
  - Any contracts expiring? Other deadlines to note?
  - Is cap table up to date?
  - Are things organized and findable?
    - It's no good to do everything if you don't know where everything is!

B. CAPITAL RAISING BASICS

First Things First

- Why are you raising capital?
  - ✓ What are your business goals?
  - ✓ How will increased capital help you achieve those goals?
  - ✓ Do you have a concrete plan for how you will use the funds?
- Is equity financing the right choice *right now*?

Capital Sources: Four Types

1. Capital from Within
   - Funding the business from personal funds of the principals:
     - Pros:
       - ✓ No dilution.
       - ✓ No loss of control.
       - ✓ No payback schedule necessarily (contrast with debt).
       - ✓ If from employees, may give them “skin in the game.”
     - Cons:
       - ✓ More limited amount of capital (unless you’re elon musk).
       - ✓ Less diversification from a personal finance perspective (even if you’re elon musk).
       - ✓ Current investors may be tapped out.

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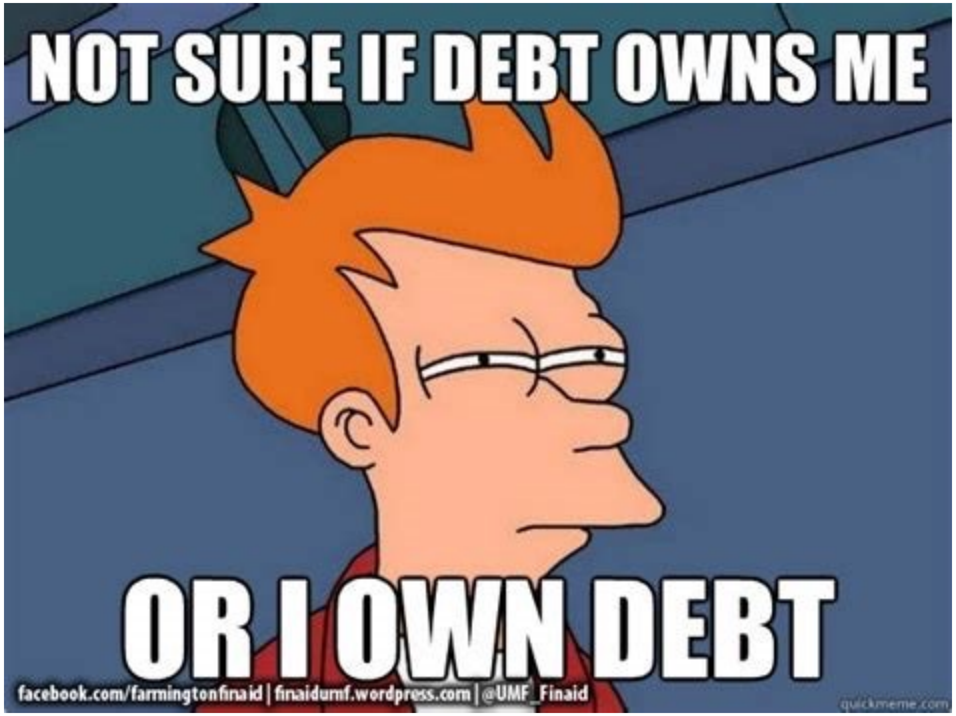
Capital Sources: Four Types

2. Capital from Within
   - Boot-strapping (reinvesting cash flow):
     - Pros:
       - ✓No dilution or loss of control.
       - ✓Managed growth, builds confidence in viability.
     - Cons:
       - ✓Only works if you have sufficient cash flow.
       - ✓Slower, harder to scale.

Capital Sources: Four Types

3. Debt
   - Borrow capital from lender(s):
     - Pros:
       - ✓ No dilution.
       - ✓ No loss of voting control (but may have negative covenants).
       - ✓ Higher potential returns if business plan works.
     - Cons:
       - ✓ Funds must be repaid with interest.
       - ✓ Priority of capital returns goes to creditors first.
       - ✓ May make raising further capital harder (debt or equity).

Capital Sources: Four Types



Capital Sources: Four Types

4. Equity*

- Raise outside capital:
  - Pros:
    - ✓ No defined payback period (usually).
    - ✓ Pari passu with other owners (usually).
    - ✓ Potential strategic value from involving other investors.
  - Cons:
    - ✓ Dilution of relative voting and economic position of existing owners.
    - ✓ Investors might want certain rights (repayment, priority, preferred return, board seats, etc.).
    - ✓ Investors might be needy or complain.
  - Hybrid: Convertible debt.
    - Converts into stock upon certain triggering events.

**Alternatively, you could franchise, but that is a topic for another day.*

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C. STEPS TO PREPARE TO RAISE CAPITAL THROUGH EQUITY OFFERINGS

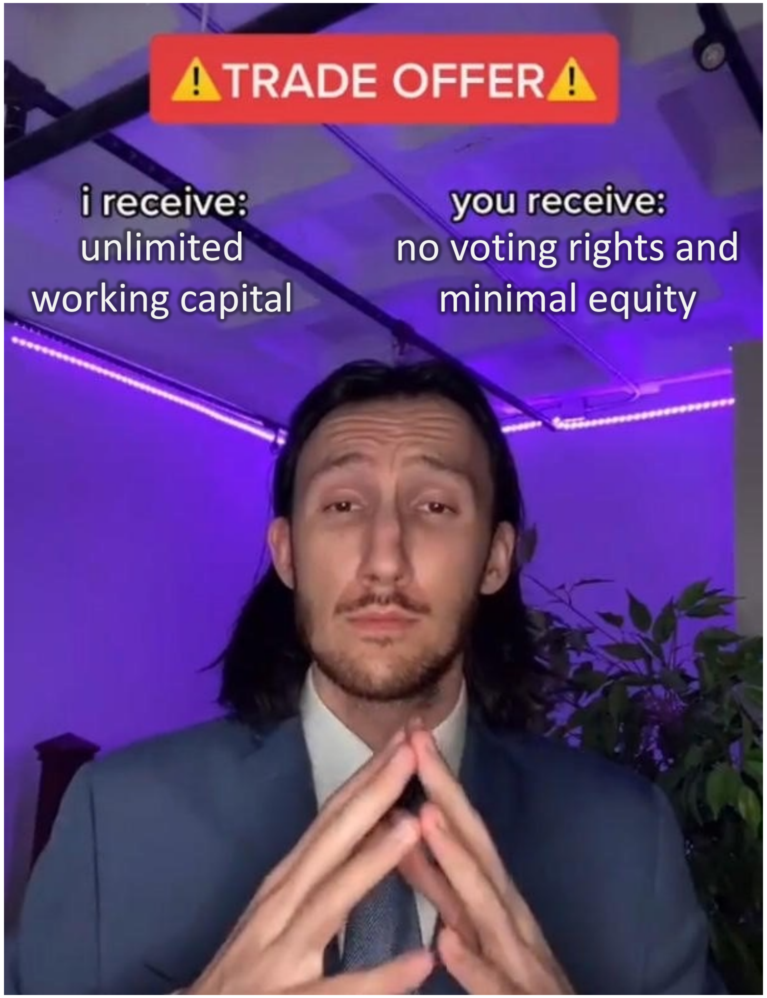
IF Equity is the Choice

- Where are you in the life-cycle of your business?
  - Startup? Early Stage? Established but Growing? Mature?
    - Options and "right choice" may be impacted by company stage.
  - Who are you talking to?
    - Friends and family
    - Angel investors
    - Venture capital
    - Private equity, family offices, larger companies, etc.
  - Do you have your advisors in place?
    - Accounting, tax, banking, and legal.

IF Equity is the Choice (continued)

- Do you know what you want?
  - How much capital? Will you need to raise more soon?
  - What form?
    - Convertible notes.
    - Equity.
    - Options/Warrants/Derivatives.
- What is your company worth (pre- and post-money)?
- What are you willing to give up?
  - How much dilution—for now?
  - How much decision-making authority?

IF Equity is the Choice (continued)



IF Equity is the Choice (continued)

- Savvy investors will want to look under the hood.
- This is where the first topic comes into play.
  - Is your legal structure in place?
    - Entity formed.
    - Governance documents.
    - Cap table is clear and cleaned up (no side deals).
    - Material contracts are in writing and in the entity name.
  - Is your business structure in place?
    - Financials are prepared and understandable.
    - Business plan and overview are written and understandable.
    - Value proposition and strategy are clear and attractive.

IF Equity is the Choice (continued)

- Do you have a deck? What about a PPM?

IF Equity is the Choice (continued)

- Have you engaged an attorney to ensure compliance with securities laws?
  - Securities laws are complex and confusing.
  - You might inadvertently sell unregistered securities.
  - Do not rely on the “happy investor exemption.”
  - There can be civil and criminal penalties if you don’t follow the rules.
  - Many exemptions available but all have requirements.
    - Accredited-investors-only is safest.
    - Less than 100 investors is safest.
    - When in doubt, disclose!

IF Equity is the Choice (continued)

Key Take-Aways

1. Get your business formalities right from the start.
2. Identify why and for what you need capital.
3. Decide whether outside equity fundraising is right for you.
4. Get your house in order.
   - <u>CLEAN UP CORPORATE DOCUMENTS, CAP TABLE, CONTRACTS, ETC.</u>
   - Figure out what you have and what you need.
5. Assemble a team of professionals.
   - CFO or outside CFO; accountant; tax advisor; banker; lawyer.
6. Go pitch!

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Thank you!

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