Venture Start-Up Kit
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Emerging Companies Practice Group

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Wiggin and Dana’s Emerging Companies Practice Group is a team of experienced professionals serving emerging growth companies and venture capital investors. We represent companies at all stages of development in high technology and other emerging growth businesses in industries such as software/information technology, telecommunications equipment, biotechnology, internet and web commerce, medical devices, clean technology, media and health care services.

Goals
We are a value-added provider of “mission critical” services to our clients. Our broad experience in representing investors and companies at all stages of their development gives us a unique perspective. We work with clients to ensure that they are structured to be scaleable – positioned for growth, capital formation and for a liquidity event. The capital structure, commercial agreements and other legal arrangements should not present obstacles to growth and must be able to withstand the rigorous due diligence scrutiny of investors, lenders, strategic partners and underwriters.

Our Approach
• Wiggin and Dana is a full-service firm which is able to service the needs of emerging growth companies at all stages.
• We seek to deliver world-class services coupled with the advantages of “presence,” proximity, local networks and a stake in this market. We also provide the advantages of “in market” rates.
• With our unique combination of skill sets, we can be a single point of contact for a client.
• Emerging growth companies are important to our firm-wide strategy.
• Our core strength is our deep understanding of the “business of technology,” coupled with our business-like approach to the delivery of services.
• Our attorneys have significant experience in the mission critical legal fields necessary to assist emerging growth companies:
  - Enterprise Formation
  - Patents Copyrights and Trademarks
  - Venture Capital Finance
  - Trade Secret Protection
  - Stock Option Plans
  - Covenants Not to Compete
  - Mergers and Acquisitions
  - Licensing and Distribution
  - Private Placements
  - Patent Litigation
  - Public Offerings
  - Intellectual Property
  - Collaborations and Strategic Alliances
  - Debt Financings

• Our attorneys are founders and leaders of the region’s most prominent technology and venture capital trade organizations, which gives us a wide network with which to help our clients. These include:
  - Connecticut Technology Council
  - Connecticut Venture Group
  - Connecticut Venture Fair
  - Connecticut United for Research (CURE)
  - MIT Enterprise Forum of Connecticut
  - Technology Transfer Advisory Committee
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Counsellors at Law

Representative Clients

Advanced BioHealing
Affinimark
Affomix
AlphaChromics
Applied Spine Technologies
Autotether
Axiom Venture Partners
AXS One
BioXcel
CardioWave
Carigent
Cartesis
Ceragenix
CE University
CGI Pharmaceuticals
CIDRA Corporate Services
CMD Biosciences
Commander Premier Aircraft Corp.
Connecticut Innovations
CoolSpine
Desmos/Tutor Trove
eLumindata
Equity Health Partners
Fortent
Foundation Source
frevvo
Genomas
Glygenix
Green Bride Guide
Grilled Cheese to Go (Cheeseboy)
GX Studios (GoCrossCampus)
Healthtrax
Higher One
HistoRx
iDevices
Innovatient Solutions
innRoad
IP Factory
itandi Group
JS Genetics
Keisense
Life Science Pharmaceuticals
Med Options
Netkey
New Haven Pharmaceuticals
NextCloud
PaperG
PhytoCeutical
Premise
Prevention Pharmaceuticals
Retail Optimization
REvolution Computing
Rhei Pharmaceuticals
Samara Innovations
Silvergate Pharmaceuticals
Sonic Golf
SurgiQuest
TwigTek
UCONN R&D Corp.
Vascular Insights
VBrick Systems
VeroScience
VeruTEK
Vion Pharmaceuticals
VRSim
Winchester Electronics
YouRenew
Emerging Companies Practice Group
Corporate Department

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Trusted Advisors to Leading and Emerging Growth Companies and Investors

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Counsellors at Law

Emerging Companies and Private Equity Group

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HARTFORD PHILADELPHIA GREENWICH
WWW.WIGGIN.COM
Getting Started

The Foundation for Growth and Financing the Emerging Company

The essentials for building a scalable business

LLC vs. Corporate Structure

Valuation – the theory and the reality

Considerations in financing a business

Sources of financing and what is best for the business model

Getting seed and pre-seed investors

The role of mentors, advisors and directors
Building the Franchise

Scalability

- IP Protection
  - Patents, Copyrights, Trade Secrets
  - Assignment/Licensing of Inventions
  - Employee Agreements/Non Competes
  - NDA’s
- The Team – management, board, advisors
- Founder Issues
  - Vesting
  - Stockholder Agreements
- Capital Structure/Nature of Investors
- Valuation
- Business/Legal Entanglements
Creating a Legal Entity

• When to Create
  – Legal Liability
  – Repository for IP
  – Formalize Relationships
• Potential Personal Liability of Directors and Officers
  – General Rule – the “corporate veil”
  – Exceptions (potential personal liability)
    -- unpaid wages, trust fund taxes, securities laws, breach of duty
    -- knowledge that a product causes harm
  – Insurance and Indemnification
    -- corporate documents and indemnification agreements
    -- product liability and D&O insurance
    -- exclusion if not in “good faith”
  – Contracts with customers/ users
    -- disclaimers of liability, instructions, disclosure of risks (but enforceability issues)

Creating a Legal Entity
Continued

• Form of Entity – LLC or C Corporation
  – LLC - is a “pass through” - losses and gains
  – C Corp - potential double taxation and losses stay with corporation
  – Common approach - form an LLC and “convert” later
  – Consider the “business model”
## Basic Differences

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxation of Income</strong></td>
<td>Double tax: at corporate level and when distributed to shareholders</td>
<td>Single tax: none to the LLC, but passed through to shareholders</td>
</tr>
<tr>
<td><strong>Laws</strong></td>
<td>• Carried forward by corporation (NOL's) to be used against future income • Possible limitation on &quot;ownership change&quot;</td>
<td>• Managers-owners can offset other income • Investors can use to offset &quot;passive income&quot; or carry-forward</td>
</tr>
<tr>
<td><strong>Grant of Equity Incentives</strong></td>
<td>• Stock options – spread taxable as ordinary income on exercise • Options &quot;vest&quot; over time • On liquidity event, possibly ordinary income on appreciation</td>
<td>• Grant of shares - not taxable (if a &quot;profits interest&quot;) • Shares subject to lapsing risk of forfeiture • Capital gains treatment</td>
</tr>
<tr>
<td><strong>Who Can Own</strong></td>
<td>No restrictions</td>
<td>No restrictions – but problematic for institutional VC’s and tax-exempt entities</td>
</tr>
<tr>
<td><strong>Special Exclusion for Qualified Small Business Stock Acquired before 1/1/12</strong></td>
<td>100% exclusion if stock held 5 years (up to 10x investment or $10 million)</td>
<td>N/A</td>
</tr>
</tbody>
</table>

## Taxation of Income

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CT R&amp;D Tax Credit/Exchange Program</strong></td>
<td>20% credit against corporation tax exchangeable for 65% of value</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Liquidity Event (Sale)</strong></td>
<td>Asset sales subject to double tax</td>
<td>Asset sales incur only single tax – enables higher purchase price since buyer can &quot;step-up basis&quot; and depreciate assets</td>
</tr>
<tr>
<td><strong>Other:</strong></td>
<td>May be better</td>
<td>Not tax free</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>OK</td>
<td>No, but may convert</td>
</tr>
<tr>
<td>Public Offering</td>
<td>Possibly taxable</td>
<td>Easier</td>
</tr>
<tr>
<td>Distribution of Assets/Reorganization</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Initial Investor Financing
Business Model and Plan
LLC v. Corporation
Debt or Equity

Equity

Consider LLC Advantages
- Pass thru of losses and gains
- Equity incentives
- Greater "back end" value on asset sale/single level of tax

Possibility of Conversion to C Corp

Sale

Plan to continue as LLC

Consider LLC Advantages
- Pass through from time of note conversion to equity
- Equity Incentives
- Greater "back end" value on asset sale/single level of tax

Plan to convert to C Corp (e.g., VC/state funding contemplated)

Consider using C Corp from outset
- Early losses remain to offset future gains, instead of being allocated to founders
- Benefits of CT R&D Exchange Program
- Potential benefits of Federal capital gains exemption

Notes

Investor Note or Equity Financing at Outset

Consider LLC Advantages
- Pass thru of losses and gains
- Equity incentives
- Greater "back end" value on asset sale/single level of tax

Plan to convert to C Corp (e.g., VC/state funding contemplated)

Consider using C Corp from outset
- Early losses remain to offset future gains, instead of being allocated to founders
- Benefits of CT R&D Exchange Program
- Potential benefits of Federal capital gains exemption

Equity Incentives

“Founders Stock”

- What is it?
  - Common Stock/Shares
  - Issued at nominal price to “Founders”

- Advantages
  - Capital Gains Rate on Increased Value
  - Voting Rights
  - C Corp - Current Income Equal to Excess of FMV over price
  - LLC “Profits Interest” – No Current Income
Equity Incentives
(continued)

Restricted Stock (Corporation or LLC)
• Shares issued, but subject to “lapsing risk of forfeiture”
• For shares in corporation, file “83(b) election”
  - Avoids tax as restriction lapses
  - Not needed for LLC profits interest
• Used for founders stock and for others
  - Tax issues for corporations post-launch and post financing
  - Generally used for subsequent LLC issuances of profits interests

Equity Incentives
(continued)

Stock Options (typically for corporations)
• How Do They Work?
  - Right to Purchase Equity In The Future
  - Vesting
  - Expiration – 10 years or 3 months post termination
  - Exercise Price = FMV
  - NQSO v. ISO
  - Pricing Issues – Discount from Preferred Stock Price
Equity Incentives

(continued)

• Stock Options Advantages / Disadvantages
  — No Current Income Upon Issuance
  — Upon Exercise:
    - No Current Income Upon Exercise of ISO (but has holding period)
    - Current Ordinary Income Upon Exercise of NQSQ

Vesting (for Restricted Stock and Options)

• Straight Line (e.g., 1/48th per month)
• Cliff (e.g., 25% after one year then 1/36th per month)
• Pre-Vesting (e.g., 25% vested, remainder vests 1/36th per month)
• Acceleration on Sale/Change of Control
• Performance based
Equity Incentives

(continued)

Size of Incentive Plan Impacted By

- Need for key hires
- Need to reallocate percentages
- Business/Staffing Plan
- Dilution Issues (if treated as part of “pre-money shares”)

Equity Incentives

(continued)

Issues in Compensating Employees Using Equity (Instead of Cash)

- Wage and Hour Laws
- Exempt (salaried) v. Non-exempt (hourly) Employees
- Independent Contractors
- Pitfalls in Valuing Private Company Equity
- Withholding
- Liability for Failure to Comply

Some “Solutions”
Founding Stockholder Agreements

• Allocation of Equity Among Founders
  – Fairness/Relative Contributions/Expected Contributions
  – “Sweat Equity” aligned with contributions (past and expected)
  – Subject to Vesting
  – Investor Reallocation
  – Board discretion

• Voting Agreement (for directors)
• Restrictions on Transfer
• Rights of First Refusal
• Tag Along Rights
• Drag Along Rights

Valuing the Business - Methodologies

• What They Teach in Business School
  – Discounted Cash Flows
  – Discounted Future Earnings
  – Sales, Net Income, Option Values, etc.

• What Really Happens
Example
Valuation Factors

The Idea
The IP Protection
Size of Market
Prototype
Competitive Environment
Quality of Team
Board/Advisors
Sales

Range: from $0 to $2.5 Million, based on satisfaction of criteria and/or weighting of criteria

Adopted from material of the Angel Capital Association

Valuation

Pre-Money Valuation (“Your ‘pre-money valuation’ is $1,500,000”)
Pre-money Valuation ÷ shares outstanding pre-financing = Price per share to be sold

E.g.: $1,500,000 “Pre-Money valuation” = $2.50 PPS
600,000 shares outstanding

Post-Money Valuation = pre-money value + amount invested
(or shares outstanding post financing x PPS)

E.g.: $1,500,000 “Pre” + $1,000,000 investment = $2,500,000 "post"

Handling of Option Reserve
Count as part of pre-money (dilutes existing stockholders)
Valuation (continued)

<table>
<thead>
<tr>
<th>Common Stock</th>
<th>Shares</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>450,000</td>
<td>45</td>
</tr>
<tr>
<td>Stock Option Plan (Reserve)</td>
<td>150,000</td>
<td>15</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Series A (as converted)</td>
<td>400,000</td>
<td>40</td>
</tr>
<tr>
<td>Total</td>
<td>1,000,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

Valuation

- Series A PPS $2.50
- Pre-Money 1,500,000.00
- Post Money 2,500,000.00

Strategy/Considerations in Financing the Business

- Goals/The Business Plan
- Need for capital
- Willingness to take dilution
- Time to market issues
- Valuation/Stage of Business
- Personal issues – self-analysis
  - Willingness to share control
  - Value of “value added”
  - Interest in accepting advice
Strategy/Considerations in Financing the Business (continued)

- Do you meet the venture capital profile?
  - Size up the management team/industry/size of market/proprietary edge
  - The business model
  - What’s hot/What’s not

- Ventures that meet the profile – choice to defer

- Ventures that do not meet the profile - raise other capital (and/or “bootstrap”) to bridge the gap

Sources of Capital

<table>
<thead>
<tr>
<th>CAPITAL SOURCES</th>
<th>Stage (Primary)</th>
<th>Amount</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bootstrapping</td>
<td>Available</td>
<td>Small</td>
<td>-No dilution</td>
<td>-Limited amounts -No long term</td>
</tr>
<tr>
<td>Private Venture Capital</td>
<td>Seed and Start-up</td>
<td>Limited</td>
<td>-May be “friendly”</td>
<td>-Value added? -Difficult to locate -Sometimes finicky -Unusual T’s and C’s</td>
</tr>
<tr>
<td>Pre-Seed Programs</td>
<td>Pre Seed</td>
<td>$10K-$50K</td>
<td>-Convertible -Constructive</td>
<td>-Convertible with kicker/discount -Geographic Restrictions</td>
</tr>
<tr>
<td>Institutional Venture Capital</td>
<td>Seed (little), start-up (some), later stages (more)</td>
<td>$500K - $100M</td>
<td>-Hands-on -Experience -Industry connections -Deep pockets</td>
<td>-Difficult to meet profile -Valuation -Tough terms/control -Expectations</td>
</tr>
</tbody>
</table>

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Sources of Capital (continued)

<table>
<thead>
<tr>
<th>CAPITAL SOURCES</th>
<th>Stage (Primary)</th>
<th>Amount</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leasing</td>
<td>Start-up/Through</td>
<td>Varies</td>
<td>- Limits commitment</td>
<td>- No equity in assets</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- Flexible</td>
<td>- Cost</td>
</tr>
<tr>
<td>Banks:</td>
<td>Seed – Start-up</td>
<td>Based on credit of borrower/guarantor</td>
<td>- No dilution</td>
<td>- Collateralized loan position</td>
</tr>
<tr>
<td>Direct</td>
<td>Later Stage</td>
<td></td>
<td>- Leverage equity</td>
<td>- Expensive</td>
</tr>
<tr>
<td>Venture Lending</td>
<td>Later</td>
<td>Based on credit of $3-10 million typical</td>
<td>- Will take risk</td>
<td>- -</td>
</tr>
<tr>
<td>Strategic/Corporate</td>
<td>All, but mostly</td>
<td>$1m – Unlimited</td>
<td>- Access to markets</td>
<td>- Constrained</td>
</tr>
<tr>
<td>Partner</td>
<td>later</td>
<td></td>
<td>- Valuation</td>
<td>- Own objectives</td>
</tr>
<tr>
<td>Initial Public Offering</td>
<td>Later</td>
<td>$20m +</td>
<td>- Access to capital</td>
<td>- Expense</td>
</tr>
<tr>
<td>(33 Act, AIM)</td>
<td></td>
<td></td>
<td>- Public burden</td>
<td>- On-going expense</td>
</tr>
<tr>
<td>Reverse merger into pub</td>
<td>Start-up/later</td>
<td>Varies</td>
<td>- Access to capital</td>
<td>- State of capital markets</td>
</tr>
<tr>
<td>ic shell</td>
<td>stage</td>
<td></td>
<td>- Public vehicle</td>
<td></td>
</tr>
<tr>
<td>Sale</td>
<td>Anytime</td>
<td>Cash-out</td>
<td>- Limits commitment</td>
<td>- Thin float/limited benefits</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- Dependable</td>
<td></td>
</tr>
</tbody>
</table>

Choosing Your Investors

- Narrowing the field
  - Industry and Stage Considerations

- Doing your due diligence

- Approaching VCs
  - Introduction
  - Lead Investor v. Member of Syndicate
Some Common Early Stage Issues

- Use of Consultants and Investment Bankers
- Employment Agreements
- Legal Issues
  - Sunset Provisions
  - Supermajority Provisions
  - Mandatory Conversions/Exercise
  - Avoid Holdouts/Holdups
  - Position for “Pay or Play” Financing
- “Sweat Equity” – Payment of Wages
- Securities Laws Exemptions – “Reg D” offering to “accredited investors”

Use of Convertible Notes

- Valuation floats until a “Qualified Financing”
- Upon QF
  - Note may or shall be converted at QF PP
  - At discount or with warrants
- If no QF by maturity date (e.g., 18 months)
  - Note can be called or (sometimes) converted at pre agreed valuation
- If company sold before a QF
Use of Angels

- Structured Angel financings v. “Private Placements”
- Ad hoc/informal v. structured networks
  - Associations (e.g., Angel Investor Forum (AIF))
  - Angel Funds
  - “Angels and demons”
- What to look for
- Advantages
- Structure of transactions
- CT Angel Tax Credit Possibility

The Venture Transaction

- Long-term cooperative relationship
- Stages of Investment
  - Getting to Know You
  - Due Diligence and Closing
  - Life of the Investment
  - Liquidity
- Key Concepts for VC Investments
  - Highly Structured
  - Downside Protection
  - Upside Equity Rights
  - Liquidity Rights
  - Control
The Venture Transaction - Process

Day 1..................30..................60..................90..................120..................150..................Day 180

• Investors Meeting
  • Initial Business Due Diligence
  • Term Sheet/ LOI
    • Business/Legal Due Diligence
    • Documentation and Closing

(continued)

• Investor Meetings
  – Focus the Search
  – Referrals Best
  – Elevator Pitch

• Initial Business Due Diligence
  – Feasibility of Business Model
  – High Level Technology Review
  – Market Analysis
  – Management, Management, Management
The Venture Transaction – Process
(continued)

- Term Sheet/LOI
  - Basic Terms
  - Non-binding, but see “no-shop” or “exclusivity” and fees
- Valuation, Valuation, Valuation
- Business and Legal Due diligence
  - Intellectual Property
  - Team
  - Business Model Assumptions
  - Business Partners/Customers
- Documentation and Closing
  - Practical Approach – Battle v. War
  - Don’t Retrade from Term Sheet

The Venture Transaction – Key Terms

- Preferred Security
  - Debt v. Equity
  - Dividends
    - Accruing/When Paid
  - Liquidation Preference
  - “Participating Preferred”
  - Conversion/Anti-Dilution Adjustments
    - Proportional for splits/combinations
    - Price protection: full ratchet/weighted average (formula)
    - Carve outs
    - “Pay to Play”
The Venture Transaction – Key Terms
(continued)

- Control
  - Board of Directors
  - “Protective Provisions”
  - Affirmative and Negative Covenants
  - Preemptive Rights
  - Rights of Refusal
- Liquidity Rights
  - Registration Rights
  - Redemption Rights
  - Drag Along
  - Tag Along

Mentors and Networks

- The value of “Networking” and mentors
  - What resources do you need?
- Formal and Informal Networking
  - Connecticut Venture Group
  - Connecticut Technology Council
  - CURE
  - Connecticut Innovations
  - YEI
  - Informal
- Degrees of Separation/working your network
- Advisors/Professionals
How to Work with Counsel/Professionals

How to Find and Select the Right Counsel?

Your business plan and needs impact the decision

- Capitalization needs / Types of Investors
- What are your products/services
- Potential markets
  - Type and geography
- Where are you headed
- Exit Strategy

How to Find and Select the Right Counsel?

Interview

- References: VCs, clients, bankers, successful entrepreneurs, accountants, trusted advisors

Do you need a full service firm?

- What tasks will be outsourced
  - Patents, visas, etc.
- Experience with start-ups

Seek professionalism and collegiality
Look for “Value Added”
**Business vs. Legal Issues**

Business issues are tactical and strategic issues involving your company
- These are your decisions
- I.D. risks and ask if unsure

Legal issues are when you analyze and quantify legal risks of the business decisions
- Counsel quantifies the risk
- You make the call

**Starting the Company**

Have “partnership” issues worked out before meeting with attorneys
- Percentages, separation, roles

Legally organize “early”

Review your existing non-compete agreements/IP issues
Starting the Company

Much legal involvement early on
- Review company name
- Formation
- Share issuances
- IP issues/protection
- Licenses
- HR/employment
- Financing

Starting the Company: Phase II

Commercial Needs
- Sales

Suppliers

Licensing / Partnering
Working Together

Much legal activity at beginning

Prepare before meetings with counsel
  • List issues you want to review

Board Meetings

Working Together

• Quick Look
  – Daily commercial deals
    • Customers
    • Suppliers
    • Banks

• Intensive Review
  • Financing Strategy and Terms
  • Property Leases
  • Strategic deals
  • Employee Termination
  • Exit Plan

• Governance – Dealing with multi-constituency board

• Evolutionary, As Experience is Gained
Fee Issues
Discuss fees and billing
Start-up costs
  • Rate Reductions
  • Deferred payments
  • Stock, warrant, option compensation
Who does what
  • Partner, Associate, Paralegal
  • “Blended Rates”
Use of Budgets and Estimates
  • Define Scope of Work (what is included)
  • Fee caps

COMMUNICATE
Getting Started

The legal considerations of starting a new business – avoiding the pitfalls and creating the proper legal structures

Part 1: Case Study: “Bleeding Edge Commerce, Inc.”

Part 2: Legal Issues

Part 3: How the Bleeding Edge Founders could have proceeded

Part 4: Conclusion
Getting Started
The Legal Considerations of Starting a New Business—Avoiding the Pitfalls and Creating the Proper Legal Structures.

PART I: CASE STUDY
Bleeding Edge Commerce Inc. (“Bleeding Edge”)
George and Pam (the “Founders”) were systems analysts with Big Red Computing Company (“Red”). Part of their activities at Red involved the development of proprietary hardware and software for a work station to be marketed to health care professionals. During their work, they become convinced that Red would be better off if it quickly entered the market by using off-the-shelf, commercially available components, which, with the new software they were developing, would meet most of the specifications of Red’s planned work station. For several weeks, on their own time and with materials borrowed from Red, George and Pam examined this concept more closely. Comparing the detailed specs of their product with the product planned by Red, they realized that their product would be cheaper and yet almost match the specifications of Red’s proposed product.

Believing that Red would not be interested in their ideas, the Founders submitted their resignations to Red. They returned to Red the material marked “proprietary and confidential.” They retained several boxes of other material they had accumulated over the years, including a copy of the source code for the software on which they were working.

Using Red’s carefully prepared market studies, the Founders drafted preliminary projections for Bleeding Edge, their new company, showing projected revenues of $200 million after five years. Based on their projections, a friend undertook to secure the needed seed money. Fifty thousand dollars was raised from widows and orphans in Vermont and Idaho.

The Founders each received a form letter from Red apprising them of their obligations to Red under non-disclosure agreements previously signed.

After several months of working in their basement, a foreign computer manufacturer (“European OEM”) became interested in their prototype and presented them with a proposed R&D contract. Although they knew the proposed contract was not perfect, Bleeding Edge now had five former Red employees and needed the cash. The Founders accepted $500,000 in advance royalties from European OEM and gave European OEM an exclusive license to their product in Europe. The contract provided for an exchange of technology and gave European OEM ownership of all enhancements made by Bleeding Edge under the R&D contract and a license to any other enhancements made by Bleeding Edge. European OEM was so interested in Bleeding Edge that it also asked for the right to invest in Bleeding Edge in the future by purchasing up to 10 percent of Bleeding Edge’s outstanding stock at $5.00 per share.

Now ready to scale up production, the Founders discussed their product in detail with numerous potential distributors as well as original equipment manufacturers (“OEM”s) interested in purchasing the product. They picked a trademark for the product, prepared manuals and began advertising.

Several large OEMs, as a condition to purchasing the product, were given the source code for the programs; the Founders were not too concerned because the software...
was copyrighted; in any event, it could easily be decompiled.

The Founders decided it was now time to seek permanent funding so that Bleeding Edge could put itself in a position to meet its projections. They became incorporated, prepared a detailed business plan and approached venture capitalists and banks. The Founders were told consistently that there were too many potential problems. The Founders told would-be investors that these potential problems could all be bought out or otherwise cured with part of the proceeds being sought.

Frustrated in their fund raising, the Founders decided that they could do without additional outside funding, whereupon:

- Red sued the Founders personally for the illegal use of its trade secrets and obtained a preliminary injunction against further use;
- one of Bleeding Edge’s OEMs introduced a product exactly like that of Bleeding Edge;
- European OEM sued the Founders and Bleeding Edge for unauthorized disclosure of its trade secrets and fraud;
- A California manufacturer claimed that Bleeding Edge was violating its trademark;
- the Vermont and Idaho investors demanded their money back, claiming fraud and violation of various securities laws by the Founders and Bleeding Edge;
- state securities officials and the SEC began investigations; and
- one of Bleeding Edge’s key technical people started his own company in competition with Bleeding Edge.

**PART 2: LEGAL ISSUES**

Obviously, the founders did a number of things wrong in this case study. Part 2 of this presentation will provide an overview of many of the substantive legal matters that may affect a start-up company.

**Trade Secrets—Protection of Proprietary Information**

Three methods of protecting proprietary information are trade secret protection, patents, and copyrights. All should be considered to protect the proprietary information of a business. In the case study, the Founders used the trade secrets of their prior employer, plus they inadequately protected their own trade secrets.

Trade secret protection is critical to a technology related company and must be considered from the very beginning to maintain the integrity of the trade secret.

**What is a Trade Secret?**

A trade secret is any formula, pattern, device, compilation or other information which is kept secret, is used in one’s business and gives a competitive advantage over competitors.

The factors to be considered in determining whether a trade secret exists are novelty, secrecy and value. Thus, matters of public or general knowledge cannot be trade secrets, although the way public information is assembled may be a trade secret. Thus, lists of customers can be a trade secret. The unique logic and coherence of software should make it protectable as a trade secret. However, once a secret is placed in the public domain, the secret is forever lost for all purposes.

The courts require that significant efforts be expended to keep the information secret. Among other things, documents should be marked proprietary and
confidential. If documents are not marked, it will be difficult to convince a court that the information is a trade secret; all conceivably proprietary documents should be labeled as such.

**Applicability in the Employee Context**

**Proprietary Information and Inventions Agreements**

It is critical that proper procedures are followed with employees. These agreements should be an integral part of a company’s trade secrets program. These agreements should be signed by all employees who have access to confidential information, preferably no later than the date each employee commences employment. Some obligations to protect trade secrets may be implied in the absence of a written agreement, particularly if the employee is a high level employee, or if each trade secret is disclosed to the employee by the company rather than independently developed by the employee during the course of employment.

These agreements serve several key functions:

- the employee is expressly agreeing not to use the proprietary information of his or her prior employer;
- the employee agrees to notify the company of all inventions made by him, whether or not they are made using the employer’s facilities, and assigns to the company all rights in this information;
- the employee may be required to identify all inventions which he made prior to his employment, thereby avoiding any misunderstanding about when an invention was made;
- the employee agrees to assist the company in seeking patent protection;
- the employee may be precluded from soliciting other employees from the former employer;
- an express agreement may make it easier to get an injunction against an employee; and
- in the absence of an agreement, the employee sometimes can retain ownership of inventions, even those made using the employer’s materials, facilities or personnel during the course of employment.

Public policy generally is against post-employment restrictions which unduly hamper an employee’s mobility. Employees may use information which is generically necessary to an employee’s work or generally known in the industry. Thus, if an employee develops knowledge about a particular type of business (a vertical market) in designing a system for that market, this is viewed as general information which can be used by the employee to develop a competing system. Similarly, even if an employer has given specialized training to an employee, the employee may be able to use that training in competition if the employee could have learned that information in similar employment elsewhere. In the software area, some courts have held that, in the absence of an agreement, the developer of software has as much right to the trade secrets in the program as his employer. This can be contrasted with the use of trade secrets in violation of a confidential relationship, such as where the employer discloses a pre-existing trade secret to an employee.

**Non-competition Agreements**

Non-competition agreements can be a valuable means of protecting trade secrets. Such an agreement may provide that the employee is precluded from competing with the company for a specified time within a specified geography following termination of employment.

Due to public policy which disfavors inhibiting people from working, a non-competition agreement will be subject to close judicial scrutiny and will only be enforceable if it is reasonable in scope and time—that is, it must relate to the employer’s reasonable business needs and it must be limited in duration. It should only be signed by key employees of the company. If the agreement is too broad, it will, depending on the state, either be totally unenforceable or be judicially construed to extend only as far as is reasonable. These agreements should be executed prior to commencement of employment, and should be referenced at the time employment is offered, including in any offer letter.

The enforceability of these agreements will vary from state to state.
Other Procedures with Employees
In addition to contracts with employees, as part of the interview process potential employees should be questioned about their understanding of the trade secrets that will be disclosed and the obligations that will arise to the company. They should also be asked about any obligations to prior employers with respect to trade secrets of that employer. The employer should stress the importance of these obligations. In some circumstances it may be appropriate to seek approval from the former employer before an employee is hired.

It may also be desirable to remind and educate employees continually about company procedures to protect trade secrets and of the techniques that may be used by others for industrial espionage.

As part of the exit process, an employee should be reminded of his or her obligations and, if possible, a termination agreement should be signed. It may also be appropriate to send a letter to the employee’s new employer putting it on notice of any agreements of the employee.

Company Trade Secrets Program
In addition to the foregoing, the owner of a trade secret should follow certain procedures to protect trade secrets. Among the things to be considered are:
- limited access to premises—limited entrances, control of service people within the plant and control of guests;
- limited access to information;
- labeling of documents;
- fairness of compensation; and
- screening of employee publications.

Relations with Third Parties
A company must also be careful in its dealings with third parties.

Anytime that the company discusses its trade secrets with a third party, the third party should acknowledge and agree that the information is confidential and proprietary. This is best done through execution of a non-disclosure information agreement by the third party.

In addition, if a third party approaches the company to discuss a proposal, the company should endeavor to have the third party acknowledge that the information is being disclosed on a non-confidential basis. It would be understood that any information received can be freely used. If it becomes necessary to receive confidential information of a third party, it would be appropriate at that point to enter into a non-disclosure information agreement.

Before providing or accepting information that may contain trade secrets, the company should consider carefully the consequences that may arise in the event that, after the information is exchanged with a third party, the potential business deal between the company and the third party does not materialize. The company will want to ensure that it is free to pursue the idea underlying the potential deal by other means while also assuring that its discussion partner will be precluded from using any trade secrets the company supplied to compete with the company. There is no boilerplate agreement that will provide the right balance for all situations, and there is no substitute for careful consideration of the terms of an agreement appropriate for the particular transaction at issue.
Patent and Copyright Protection

Patents

A patent grants to the owner the exclusive right to exclude others from making, using or selling a claimed invention, but not necessarily the right to make, use or sell the invention. Other than with respect to design patents, the term for patents that are in effect, and patents issuing from applications that are pending, on June 8, 1995, have a term measured by the longer of seventeen years from grant or twenty years from filing. Patents (other than design patents) issuing from applications filed on or after June 8, 1995 have a twenty-year term of exclusivity. Design patents have a term of 14 years from the date of grant.

The subject matter of a patent must be a machine, manufacture, composition of matter or an improvement thereof. In addition, not all trade secrets are patentable. To be patentable, the invention must be novel and not obvious. In addition, the subject matter must be patentable.

Because a patent requires a full disclosure of what was invented, it is not possible to patent an invention and still keep the invention as a trade secret.

Copyrights

Copyrights protect a form of expression and not the ideas or techniques embodied in the work. Thus, although a document or a book or a computer program can be copyrighted, the ideas contained in the copyrighted work cannot be protected by copyright. With respect to material which is licensed or sold, trade secret protection should be carefully considered in addition to copyright protection.

Copyright protection is automatic; the copyright attaches upon creation. The work should be marked with the copyright notice. If the copyright is registered, various other advantages inure, including the right to sue for infringement.

Trade Secrets Program for Software

Copyright and trade secret protection can be significant protections for computer programs. The copyright protects against the unauthorized copying of the program. However, without trade secret protection, users could acquire trade secrets that may be embodied in the computer programs and use the trade secrets in an altered form in their own program. In addition, there is the practical problem of enforcement that would be presented if users could easily get access to the source code, because it can be very difficult to detect whether a competitor has used the trade secrets contained in a program.

Computer programs should be licensed rather than sold. Under a license, the licensor can retain title to the trade secrets and control the use and disposition of the product by the customer and the modification or adaptation of the program. The customer would not be permitted to decompile the object code into source code. The license agreement should either be signed by the licensee, or in the case of mass-marketed software, the license should accompany the program and a mechanism should be established whereby the licensee is deemed to have accepted the license by breaking the seal on the diskette or acknowledging acceptance of the license before the program installs itself. There are numerous practical steps that should also be considered to protect trade secrets and to detect their misappropriation.

Software source code escrows can be used to satisfy a number of different needs. They are often used where the licensor is unwilling to give the source code to the user, but the user is concerned with potential loss of availability of the software in the event of destruction of the licensor's copy or in the event the licensor is unwilling or unable to support the software, such as if the licensor goes out of business. Enhancements and technical documentation may also be turned over to the escrow company, and the escrow company may be called upon to provide other services such as verification of source code deposits.

The escrow service will secure the material. Typically, there will be an agreement between the licensor and the licensee, and escrow instructions to the escrow agent governing when the escrowed material will be turned over to the licensee. The objectives of the licensor can be met through an escrow because it can safeguard its proprietary information; to a lesser degree, the interests of the licensee can be met because it can, under limited conditions and subject to certain bankruptcy law issues, have access to the source code with all enhancements so that it can take over maintenance of the software.

Trademarks, Service Marks and Trade Names

A trademark is a word, name, symbol or device used by a producer or seller to identify its goods and to distinguish them from the goods of another. A service mark is a word, name, symbol or device used to identify an entity's services and distinguish them from the services of others. The breadth of what may qualify as one of these marks is extensive.

Trademarks and service marks can be registered at both the federal and the state level. It is important to perform a search prior to using a mark to ascertain whether it may conflict with the mark of
The strength of a trademark will be determined by its uniqueness. A “coined” or “fanciful” mark, an invented word without independent meaning, is the strongest. Examples of this are “Kodak” and “Exxon.” “Arbitrary” marks such as “Shell” for oil and “Admiral” for appliances are words which have no meaning with respect to the particular goods and, while not as strong as “coined” or “fanciful” marks, are stronger than “suggestive” marks. “Suggestive” marks, which are less strong than “arbitrary” marks but stronger than “descriptive” marks, have an indirect meaning with respect to the goods. Examples of “suggestive” marks include “Habitat” for home furnishings and “Greyhound” for bus transportation services. “Descriptive” marks are words or terms which directly convey some meaning regarding the goods. Although descriptive marks are weak legally, they are often the most preferred for marketing reasons. Examples of “descriptive” marks include “tender vittles” for cat food and “world book” for encyclopedias.

State and Federal Securities Laws
Registration Requirements

A major consideration in forming a company is compliance with state and federal securities laws.

Under the Securities Act of 1933 (the "Securities Act"), a security cannot be sold unless it is registered or unless the security itself or the transaction in which the security is sold is exempt from registration. The exemption that will be most important to the founders of a company is the so-called private offering exemption which exempts sales of securities in issues not involving a public offering.
An issuer can conduct a private placement under the procedures that have been commonly accepted for private placements pursuant to Section 4(2) of the Securities Act, or it can conduct private placements pursuant to the Regulation D “safe harbor” under the Securities Act. Under the Section 4(2) exemption, offers can only be made to individuals who can bear the economic risk of the investment and who, either alone or with an offeree representative, are sophisticated investors. In general, offers can only be made to a limited number of persons, other than certain sophisticated institutions. The offering must be made in direct communications with offerees, not through general advertising or mass media circulation. Generally, the issuer also has the obligation to supply information to the offeree. Finally, the purchasers are required to have an investment intent with respect to the securities purchased.

Regulation D, which contains a series of rules (numbered 501–506) promulgated under the Securities Act, was adopted by the Securities and Exchange Commission (“SEC”) to provide certainty in the area of private placements.

The steps that must be taken to comply with Regulation D depend upon the size of the offering. Offerings of $1,000,000 or less have the least federal compliance requirements. Among other things, there may be an unlimited number of investors and no information requirements are specified, although individual states typically limit the number of investors and some states require that specific information be disclosed. For offerings greater than $1,000,000, there can be no more than 35 purchasers plus an unlimited number of “accredited investors;” in addition, if any non-accredited investors are involved, substantial information requirements must be met; if purchased solely by accredited investors, no information requirements are specified. However, even where no information requirements are specified, adequate disclosure should be provided under the antifraud provisions of the securities laws.

In addition to institutions, business development companies, charitable organizations and insiders, the following would constitute accredited investors:

(a) certain entities having total assets in excess of $5,000,000;
(b) a natural person who, together with its spouse, has a net worth in excess of $1,000,000; and
(c) a natural person with income over $200,000 (or $300,000 with spouse) in each of the last two years and who reasonably expects an income in excess of that level in the current year.

In addition to the federal securities laws, the company must comply with the securities (or “blue sky”) laws in each state in which its securities are being offered. The issuer must be certain (1) that the offer and sale of securities in that state are exempt from registration in that state and (2), even if exempt, whether a filing in that state is required. The exemptions from registration under state securities laws are not completely parallel to those under federal laws and must be carefully examined. Some states require a filing prior to the offer of any securities in that state; other states require filings to be made subsequent to the sale of securities. Some states also require the disclosure of information to potential investors, or may require that investors have the option to rescind their investment within a specified time.

Misrepresentation
Even if a transaction is exempt from the registration requirements of applicable securities laws, the issuer must be sure that it will not be liable for any misrepresentation. In addition to remedies under common law, the federal securities laws make the issuer liable for any offers or sales of securities which include an untrue statement of material fact or omit to state a material fact necessary to make the statements, in light of the circumstances under which they were made, not misleading. One well known basis for liability is under Rule 10b-5 of the Securities Exchange Act of 1934 promulgated by the SEC.

Remedies for Violating Securities Laws
In addition to a suit for damages and possible criminal penalties, a purchaser of securities may rescind his transaction by recovering the amount paid for the securities if he can prove that the issuer should have registered the securities under applicable securities laws, or that there was any misrepresentation within the meaning of the securities laws in connection with the offer or sale of the securities.

Restrictions on Disposition
One of the requirements for a valid private placement is that the purchaser acquire the securities for investment purposes without a view to distribution thereof. As a safe harbor, the SEC has adopted Rule 144 under the Securities Act which provides a safe harbor in connection with the disposition of securities of public companies. After holding the securities for one year, the purchaser is permitted to sell the securities in accordance with the volume restrictions, manner of sale provisions and other provisions of Rule 144; if the
purchaser is not an affiliate, the purchaser can freely sell the securities of the company after two years.

**Corporate Documentation**

**Incorporation**

The first issue facing the founders in forming their company is whether to incorporate as a corporation or to form a limited liability company ("LLC"). The LLC has emerged in recent years as a popular form of small business entity because it provides limited liability for its founders, as a corporation does, while providing tax advantages for many businesses. Earnings for an LLC are taxed only at the level of its members, like a partnership (although its founders may elect to have the LLC taxed as a corporation). If the founders anticipate that their business will be profitable, self-funding and able to make payments to the members sufficient to cover their tax liability, they may wish to explore the possibility of forming an LLC. On the other hand, if the founders expect significant start-up losses, they may wish to retain those losses in the corporation to carry forward to offset against future earnings and tax liability. Individual (or "angel") inventors may have their own preferences based on their personal tax situation. Additionally, if the founders plan to seek outside investors in the business, they should be aware that the corporation remains the entity of choice for most venture capital investors. If they aspire to "go public," the entity will need to be a corporation, although it is generally possible to convert an LLC to a corporation prior to an IPO.

A question often discussed is whether to incorporate in Delaware or in the state in which a company's principal place of business will be located. The corporation law of Delaware is widely understood and has been interpreted in many respects by the courts, including the Delaware Chancellory Court, created for that specific purpose. Although the corporation laws in many states have been modernized so that there is little, if any, legal difference from the statutory corporation laws of Delaware, most of the states do not have well developed case law in the area. Delaware is often chosen for "emerging growth" companies because its law is most widely understood and interpreted and it is usually at the forefront in adopting progressive changes. In many cases, the difference is only one of perception; if the company plans to grow and possibly become a public corporation, it may wish to start off as a Delaware corporation, because incorporation under Delaware law may have a national image associated with it and sources of funding continue to favor it. It is possible for a corporation to reincorporate as a Delaware corporation at a later time if this becomes an issue.

While the remainder of this section focuses on corporations, similar documentation and concerns are applicable to other entities such as an LLC.

The most basic documents in forming a corporation are the certificate of incorporation and bylaws. The certificate of incorporation is typically filed with the secretary of state of the state in which the company is incorporated. A corporation typically begins its legal existence when the certificate of incorporation is filed. The bylaws of the company provide for the manner in which the company will conduct its affairs, its rights or powers, the rights or powers of its shareholders, directors or officers and other matters not inconsistent with the certificate of incorporation and the law of the state of incorporation.
It is critical that the proper corporate formalities be observed in connection with managing a corporation. The shareholders of the company elect the board of directors. Generally, the business of the company is to be managed under the direction of the board of directors. The board of directors elects the officers and passes on major actions by the corporation as well as other activities upon which the laws of the state of incorporation, bylaws, certificate of incorporation or agreements require that the board act. The only exception to this in some states is if the corporation has properly elected to be run as a “close corporation,” in which case the stock-holders can manage the company.

Board meetings should be held (or written board consents executed) regularly; shareholder meetings should be held (or written shareholder consents executed) when required; proper minutes of meetings should be maintained; the minute book should be kept up to date; and proper records should be maintained. Without the observance of the proper formalities, it may be possible for a plaintiff to “pierce the corporate veil,” that is, sue the shareholders of the corporation personally for the acts of the corporation.

**Founders’ Stock**

The founders of a company are often issued stock at a price which is substantially below the price which is paid by investors. The founders, as well as any other employees who are issued stock, may be requested to sign agreements whereby the company has the right to repurchase such stock in the event the employee leaves the company’s employment within a specified period of time. A so-called “vesting” schedule often provides for a decreasing percentage of such stock to be subject to this repurchase option based on the time the employee works for the company. These arrangements may be important because an employee can be provided with incentive through stock but yet not fully reap the benefits of the stock if he or she leaves within the vesting period. In addition, the repurchased stock is available for issue to replacement employees without incurring further dilution. If restricted stock is purchased or granted, tax advice must be obtained concerning appropriate elections under Section 83(b) of the Internal Revenue Code of 1986.

**Shareholder Agreements**

The shareholders of a corporation will often desire to provide for certain rights and obligations among themselves, as shareholders.

One common agreement is a buy-sell agreement among the founding shareholders. In the event of the death of a party to this agreement, the corporation will be required to buy back the stock of that person at a price which is either fixed in the agreement, agreed to periodically on a schedule to the agreement or determined pursuant to a formula in the agreement. The corporation may obtain life insurance (key man insurance) to cover this obligation. Buy-sell agreements can be effective estate planning devices to provide liquidity to the estate of a shareholder. These agreements may also provide for certain procedures to be followed in the event of a deadlock regarding the management of the company.

Rights of refusal or offer are often provided for in shareholders’ agreements. In a closely held company, it may be important that a shareholder not be free to sell his stock to a third party without first offering it to the company. The company could be given the first option to buy a shareholder’s stock; other parties to the agreement may be given the right to buy the stock in the event that the company does not buy it.

Shareholder agreements may also provide for the designation of nominees to the board of directors. Certain shareholders may be given the right to nominate directors, and the other parties of the agreement may agree to vote their shares in favor of such nominees.

**PART 3: HOW THE BLEEDING EDGE FOUNDERS COULD HAVE PROCEEDED**

Looking back to the case study in Part I, the Founders began violating the proprietary rights of Red when, on their own time and with materials borrowed from Red, they conceptualized a product which they did not intend to disclose to Red. They used the detailed specs of the planned Red product and the pricing information that had been developed by Red, all proprietary information of Red. Faced with this, the Founders should have considered disclosing their idea to Red and, if Red was not interested, seeking a release from Red prior to their termination of employment. Another alternative might have been to have waited until the Red product was placed on the market, whereupon the pricing information and presumably the specs of the Red product would have become public information. The Founders might then have been in a position of not having to use proprietary information of Red. Obviously, if the Founders did not use proprietary information of Red, their situation would have been radically different. Red could not have stopped them, in the absence of a non-
competition agreement, from using their general knowledge of this particular vertical market to go into competition with Red.

Although the Founders returned the boxes of documents that were marked “proprietary and confidential,” the other material retained by them may still have been proprietary to Red even though it was not so marked. Certainly, the source code would have been proprietary, and the Founders would have had a difficult time convincing a court that they did not know that it was proprietary. To avoid any question, the Founders should have returned to Red all documents of Red; their objective should have been to put themselves into a position that they could convince a court that proprietary information of Red was not used in connection with the development of their product. Boxes of documents, even innocuous documents, could create an unfavorable impression in the mind of the court.

The dilemma of whether to approach or avoid the prior employer is often presented in start-up situations. This decision should be carefully explored and any conclusion will be based on the facts of each particular situation. If the employee does not believe he will be in violation of his trade secrets obligations, he may wish to totally avoid discussions with the prior employer. Among other things, discussions may tip off the employer as to the employee’s intent. On the other hand, even if the prior employer does not request an exit interview, the employee may wish to notify the employer that he is aware of his trade secrets obligations, and that, to avoid any future misunderstandings, he wishes to document the work in which he was involved and any proprietary information to which he may have been exposed during his employment. This would create a good framework for the employee to pursue his new endeavors. If the prior employer refuses to cooperate, this may still work in the employee’s favor in view of the public policy against restricting mobility and the demonstrated good faith of the employee.

To raise their initial funds, the Founders should have disclosed more than simple projections. For the sale of securities to be exempt under federal and state securities laws, the Founders should have carefully observed the requirements of Regulation D as well as of the securities laws of Vermont and Idaho. Substantially more information about the business of Bleeding Edge should have been prepared. Even if the offering is small enough so that Regulation D does not require any particular information, state securities laws might still require disclosure; in addition, to avoid a charge of fraud, the Founders should have described all material facts relating to Bleeding Edge, especially significant “risk factors.” In particular, the obligations of the Founders to Red, and potential charges by Red, should have been described.

In the haste to obtain funding from the European OEM, the Founders may have failed to negotiate several points which may provide long term problems. For example, the exclusive license in Europe and the right to all enhancements made by Bleeding Edge may have precluded Bleeding Edge from competing in Europe; furthermore, with access to all of Bleeding Edge’s technology, European OEM may have become a competitor of Bleeding Edge. Problems also could have been created by European OEM’s ownership of all work done under the R&D contract. The warrant also had
several negative features. Options and warrants would overhang the capital structure of a company. In this case, the warrant gave European OEM the nondilutable right to purchase 10 percent of Bleeding Edge’s stock outstanding at a specified price per share. Thus, it would complicate Bleeding Edge’s sale of stock to an investor in the future at more than $5.00 per share, because such an investment would be diluted upon exercise of the warrant. Arrangements of this nature can be a very attractive means of financing a company; however, they must be carefully negotiated, because they often contain covenants, restrictions and rights which can significantly impact the future operations of the company.

In discussing the product with potential distributors and OEMs, the Founders should have required the execution of non-disclosure agreements by these third parties. Failure to do so could have resulted in disclosure of their own trade secrets as well as trade secrets of European OEM, thereby causing the loss of their trade secrets and liability to European OEM.

Before preparing manuals and beginning advertising, the Founders should have searched their trademark to ascertain whether it infringed any existing trademark. This could have minimized the risk of an infringement claim by another manufacturer with similar products and a similar trademark.

It appears from the case study that several large OEMs required disclosure of the source code so that they could be guaranteed the ability to maintain the product. A deposit of the source code with an independent escrow agent may have been appropriate here; this would have preserved Bleeding Edge’s control of the source code. In addition, the software should not have been sold to the OEMs, but should have been licensed. Even though the software was copyrighted, upon sale the purchaser had the right to decompile and cross-compile it. The Founders would also have no control over the use of the software by the OEMs, such as for time-sharing. In addition, the Founders should have taken additional practical steps to preserve the trade secrets in the software and to help detect misappropriation. These steps would have permitted the Founders to retain their proprietary information as a trade secret and to have adequately protected the proprietary information of European OEM.

Of course, the Founders should have become incorporated no later than the time when they began entering into arrangements which gave them potential legal exposure. By not being incorporated, the Founders might be personally liable for their pre-incorporation actions.

In addition to proprietary information agreements with third parties, the Founders and the other employees of Bleeding Edge should have signed proprietary information and inventions agreements with Bleeding Edge. In addition, any assets necessary to the conduct of Bleeding Edge’s business which were not owned by Bleeding Edge should have been assigned to it; this would include any intellectual property which the Founders may have developed prior to the incorporation of Bleeding Edge and their execution of proprietary information and inventions agreements. In addition, the Founders should have considered having key employees execute non-competition agreements.

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**PART 4: CONCLUSION**

In a start-up situation, the founders will be busily engaged in a myriad of activities, including getting their product ready, hiring staff, writing a business plan and trying to secure funding. Often, what may appear as unimportant can plague them later. As part of the decision process, each action and decision should be analyzed with the question in mind of how it will restrict the future activities of the company and how potential investors will view it.

If the company plans to attract financing from a third party, be it a bank, an insurance company, a venture capitalist or through a private placement, the lender or investor, as part of its due diligence, will require that the company’s house be in order. Failure to observe the corporate formalities, or entanglements with vendors, customers and other parties, can result in critical delays in financing or may possibly abort a potential financing. If the company’s objective is to grow into a larger company and seek liquidity for its shareholders through a public offering or sale, the company should strive to conduct its business from its very inception with an eye on “scalability,” as though it is a large company.

—*Frank J. Marco, Esq.*

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**Venture Start-Up Kit**
Venture Capital Financing

Legal Documentation and the Term Sheet

OVERVIEW OF LEGAL DOCUMENTATION
- Purposes of Term Sheet
- Documentation in General
- General Approach in a Venture Capital Transaction
- The Purchase Agreement
- Basic Purpose of Documents

HYPOTHETICAL TERM SHEET WITH COMMENTARY
- Basic Terms
- Description of Preferred Stock
- Preferred Stock Purchase Agreement
- Management/Employee Arrangements
- Nonbinding Effect
We can now assume that a venture capitalist is ready to make an investment in a start-up Company and has begun the actual negotiation of terms. At this point, it is customary for the venture capitalist to prepare a term sheet summarizing the proposed principal terms under which it would invest.

Purpose of the Term Sheet

- Focus attention of parties on the principal terms of the transaction so that an informal meeting of the minds can be reached.
- Provide a framework for the preparation of definitive legal documents and the consummation of the transaction.

Before discussing the detailed provisions of the term sheet, it is useful to understand the results to be accomplished by legal documentation. Many of these are discussed more fully in the Term Sheet below.

Documentation in General

General Approach in a Venture Capital Transaction

The basic objective of the venture capitalist and the Company is to consummate a financing of the Company, under terms that are desirable for all parties, so that the Company can either begin or continue to develop through a long-term cooperative effort between the investors and the Company. The business, personal and legal relationships which are established during the negotiation of the terms of the transaction and the preparation and finalization of documents are the foundation for this process.

The investor will desire to accomplish the investment through documents embodying terms and conditions which it considers customary and reasonable. However, there are numerous areas that are properly the subject of negotiation. The investor’s counsel will typically draft the documents and negotiate them with counsel for the Company. The Company should work closely with its counsel since certain provisions of these documents could have immediate impact, while others, though of no immediate consequence, may have a significant future impact on the Company.

The Purchase Agreement

The Purchase Agreement is the basic document in an investment; it defines the rights, duties and obligations of the Company issuing the securities and of the investor that is purchasing the securities. The form of the Purchase Agreement will be generally the same whether the security to be purchased is Common Stock, Preferred Stock, subordinated debt, warrants or any combination thereof. Typically, the following documents are attached to the Purchase Agreement as schedules or exhibits:

1. Disclosure Schedules;
2. The security (e.g., the form of an amendment to the Company’s certificate of incorporation, the form of the debt instrument and/or the warrant);
3. Form of Confidential Disclosure Agreement;
4. Form of Non-Competition Agreement;
5. Form of Shareholders’ Agreement;
6. Form of Opinions of Counsel; and
7. Form of Stock Option Plan or Employee Stock Purchase Plan.
The term sheet which follows illustrates how the above purposes will be accomplished through the legal documentation of a proposed investment in “Venture Company.” Since the purpose of a term sheet is to provide a framework, it typically does not treat all significant terms of the transaction.

**Basic Purpose of Documents**
The documents in a venture capital financing are designed to accomplish the following basic purposes:

1. Provide for the purchase and sale of the security.
2. Accurately describe the Company on the date of execution of the Purchase Agreement. This is done through the representations and warranties in the Purchase Agreement.
3. Describe the conditions to be fulfilled by the Company before the investor is obligated to close. This is done through the conditions to closing in the Purchase Agreement.
4. Describe how the Company will operate after the closing. This is done through the affirmative and negative covenants in the Purchase Agreement or the Shareholders’ Agreement.
5. Provide for the investor’s liquidity rights and downside protection rights. This is done through the registration rights in the Purchase Agreement, Shareholders’ Agreement or separate Registration Rights Agreement and the redemption and liquidation rights in the security to be issued.

**HYPOTHETICAL TERM SHEET WITH COMMENTARY**

**Purchase of Series A Convertible Preferred Stock of Venture Company**

**Summary Of Terms**

**Basic Terms**
1. Amount Of Investment: 2,000,000 shares of Series A Preferred Stock ("Preferred Stock")
2. Price: $1.00 per share
3. Post Financing Capital Structure:

<table>
<thead>
<tr>
<th>COMMON STOCK</th>
<th>NUMBER OF SHARES</th>
<th>PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder No. 1</td>
<td>800,000</td>
<td>20%</td>
</tr>
<tr>
<td>Founder No. 2</td>
<td>600,000</td>
<td>15%</td>
</tr>
<tr>
<td>Founder No. 3</td>
<td>200,000</td>
<td>5%</td>
</tr>
<tr>
<td>Reserved for issuance to key employees</td>
<td>400,000</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,000,000</strong></td>
<td><strong>50%</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PREFERRED STOCK</th>
<th>NUMBER OF SHARES</th>
<th>PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors</td>
<td>2,000,000</td>
<td>50%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,000,000</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
**Comment:** Section A describes what the basic capital structure of the Company will be after giving effect to this issuance. Details regarding the restrictions on the Common Stock to be issued to the Founders and on Common Stock to be reserved for other employees are covered elsewhere.

**Description of Preferred Stock**

**Comment:** The terms of the Preferred Stock will be contained in an amendment to the Company’s certificate of incorporation or in a certificate of designation to be adopted by the Company’s board of directors; in either case it will be attached as an exhibit to the Purchase Agreement.

1 | DIVIDENDS:
Cumulative dividend of $.10 per annum beginning in year four;

**Comment:** The above dividend, which begins four years after the closing, will be cumulative regardless of whether the Company has sufficient earnings under the corporation laws of the Company’s state of incorporation. Other typical provisions are:
- dividends accrue from date of issuance;
- “participating dividends” whereby the preferred will participate with the Common in any dividends in excess of the stated dividend;
- no stated dividends, but participation only on the same basis as the Common;
- cumulative dividends only to the extent earned;
- dividends cumulative only after the Company hits minimum earnings amount;
- noncumulative dividends;
- right of Preferred Shareholder to receive cumulative dividend in shares of Preferred Stock or shares of Common Stock;
- escalation in stated dividend if dividends are earned, but not paid; and
- right to elect additional directors if earned dividends are not paid.

The dividends provision described above, the liquidation preference and other terms of the Preferred Stock help substantiate the founding Shareholders’ claims that the Common Stock purchased by them (at a nominal price) prior to the Preferred Stock closing was purchased at fair market value and was not “cheap stock,” which could constitute taxable income to them.

2 | LIQUIDATION PREFERENCE:
Senior to Common Stock in all liquidations. Amount:

a) involuntary liquidations—
$1.00 per share plus accumulated dividends;

b) voluntary liquidations—
$1.00 plus 20 percent per year through year five, plus accumulated dividends.

Consolidation or merger where the Company is not the surviving corporation, or sale of all or substantially all assets, regarded as a voluntary liquidation.

**Comment:** Preferred Stock will typically be senior to Common Stock in the event of the Company’s liquidation, dissolution or winding up.

The above liquidation preference is designed to return to the investors (to the extent funds are available) their investment in the event the Company is liquidated or sold. In lieu of receiving the liquidation preference, the investor could elect to convert into Common Stock if this is more desirable. Other typical provisions are:
- participation with Common Shareholders after payment of the liquidation preference, or participation only after the Common Shareholders have also received an amount equal to the liquidation amount
- in event of merger, consolidation or sale of assets, in addition to rights to convert to Common or to receive liquidation preference, holders of Preferred can elect to have the Preferred become convertible into the securities or property that the Common holders receive
- merger, consolidation or sale of assets not regarded as a liquidation.

3 | REDEMPTION:
Redeemable at election of Preferred holders beginning December 21, 2006, at redemption price of $1.10 per share plus accumulated dividends.

**Comment:** The investor will typically want the ability to cause redemption at its option to achieve some liquidity and some return on the investment in the event the Company is only moderately successful. Other typical provisions are:
- redemption at Company’s option beginning at a specified future date;
- mandatory redemption-sinking fund redemption in accordance with a redemption schedule;
- redemption price based on a formula (e.g., ten times earnings per share) or fair market value;
- Company option to pay redemption amount in installments; and
- redemption triggered by breach of representation, warranties or covenants made to the investors.
Venture Capital Financing

continued

4 | CONVERSION:
a | Conversion Price: $1.00 per share.
   
Comment: This one-for-one initial conversion price allows the holder of Preferred Stock to convert each share of Preferred Stock into one share of Common Stock. Conversion generally will not take place unless
   (i) there is automatic conversion, as described below,
   (ii) the holder of Preferred Stock wishes to sell in a registered public offering or pursuant to an exemption from registration (e.g., rule 144), or
   (iii) it is desirable to convert into Common to receive the benefits of the Common in connection with a merger or sale, or before the Preferred is redeemed by the Company pursuant to a Company redemption right.

b | Automatic Conversion:
   Upon a firm commitment underwritten public offering covering primary sale of Common Stock at offering price per share of $5.00 or more with gross proceeds of $20 million or more.
   
Comment: This provision will facilitate simplification and improvement of the Company’s capital structure prior to a primary public offering. The public offering must be of the specified minimum dollar amount and have a per share offering price at some multiple of the purchase price (in this case, five times the $1.00 per share purchase price). It is sometimes agreed that the Preferred Stock will also be automatically converted if the Company hits specified earnings targets or if a specified amount of additional stock is sold at a specified price.

c | Antidilution Protection: Proportional adjustments for splits, stock dividends, recapitalizations and similar corporate events. Full ratchet adjustment for issuances below the Conversion Price. Exceptions for Common Stock issued upon conversion of Preferred Stock and for 400,000 shares to be issued pursuant to Employee Stock Purchase Plan.
   
Comment: The investor will want protection against issues of stock in connection with splits, etc. so that its right to purchase Common Stock is not adversely affected. For example, if the Company had a two-for-one stock split, the Conversion Price would be proportionately adjusted from $1.00 to $.50 and each share of Preferred Stock would become convertible into two shares of Common Stock.

   The investor will also want protection against dilution from issues of “Additional Shares of Common Stock” at a price per share which is less than the Conversion Price. The terms above provide for a “full ratchet,” whereby the investor receives full price protection; the Conversion Price is fully reduced to the price of the new issue, regardless of the relative size of the issue. Another method of adjustment is “weighted formula” adjustments which factor in the number of new shares issued, the price per share and the number of shares outstanding prior to such issue. The antidilution adjustment can also be designed to operate if a Company issues stock at a price per share less than the current market price.

   A “pay to play” provision would require, as a condition of any adjustment to its exercise price as a result of the antidilution provision, that the holder purchase its preemptive share in any dilutive issuance.

   The antidilution provision must take account of the number of shares to be reserved for employees and any other issuances (for example, in connection
with a strategic partnership, the acquisition of another company, a debt financing or a leasing transaction) which will be carved out from the operation of the antidilution provisions.

5 | VOTING RIGHTS:
   a | General Voting:
   Holders of Preferred Stock vote with Common and each holder has number of votes equal to number of full shares of Common Stock into which its Preferred Stock is convertible.
   Comment: This is a common voting provision; it gives the holders of the Preferred Stock the right to vote on an "as if" converted basis.
   b | Election of Directors:
   Holders of Preferred Stock can elect two directors; holders of Common Stock can elect two directors; one director elected by Preferred and Common voting as a single class; in the event of the breach of any covenant in the Certificate of Designation or any material covenant in the Purchase Agreement, holders of Preferred Stock can elect two thirds of all directors.
   Comment: The above provision provides for a balanced board. There is often extensive negotiation over the number of directors to be selected by each class and the means for electing additional directors.

   The by-laws, the certificate of incorporation or both typically will fix the number of directors. In this case, the number of directors is fixed at five. The Preferred Shareholders and the Common Shareholders could enter into a voting agreement providing that the fifth director will be selected by the two nominees of the Preferred Shareholders and the two nominees of the Common Shareholders.

In addition, the investors will often want to agree among themselves for the right of certain investors to designate one of the nominees of the Preferred Shareholders. These provisions will typically be formalized in a Shareholders’ Agreement.

An equally important issue for the Company is identification of the investor’s director designee and appropriate due diligence, to be sure the person has the experience, capabilities and personality that is best for the Company.

Breach of specified covenants will give the Preferred Shareholders control of the Board until the breach is cured. The election of directors can operate as an effective means, within the confines of applicable corporation law, to accomplish actions which the Preferred Shareholders desire.

   c | Veto Rights: Usual and Customary
   Comment: The holders of a senior security such as the Preferred Stock will typically reserve the right to approve, by at least the vote of the holders of a majority of the shares of Preferred Stock, all significant corporate transactions (mergers, consolidations, sales of all or substantially all assets), changes in the certificate of incorporation or by-laws which would adversely affect the rights of the Preferred Shareholders, the declaration of dividends or the making of distributions on Common Stock, the redemption of Common Stock, or the issuance of any securities senior to or on a pari with the Preferred Stock. These provisions are often specified in the term sheet.

Preferred Stock Purchase Agreement

1 | CLOSING: ________, 200__

2 | REPRESENTATIONS AND WARRANTIES: Usual and customary representations and warranties for a start-up Company.

   Comment: Representations are specific, detailed (and often over-lapping and redundant) factual statements about a Company and its organization, business, operations and prospects. They are designed to provide a picture of the Company, elicit any problems and provide full disclosure to investors. They may alert the investor to whether the Company’s business and operations are properly administered. They may also serve as statements of intent which make it clear how the investors expect the Company to operate. Exceptions and other statements necessary to make the representations and warranties accurate will be set forth on the Disclosure Schedules attached to the Purchase Agreement. Although a misrepresentation or breach of warranty could result in a suit for damages or to rescind the transaction, the primary purpose is not to build a basis for a lawsuit but to obtain full disclosure and avoid misunderstandings.

   Typical representations and warranties will cover (i) organization and corporate power, (ii) subsidiaries, (iii) capitalization, (iv) authorization of the transaction, (v) contracts and commitments, (vi) financial statements, (vii) undisclosed liabilities, (viii) adverse changes, (ix) tax matters, (x) transactions with affiliates, (xi) litigation, (xii) consents, (xiii) title to properties, liens and encumbrances, (xiv) leases, (xv) patents, copyrights, trademarks, etc., (xvi) compliance with securities laws, (xvii) compliance with other instruments, (xviii) employees, (xix) business, (xx) use
of proceeds and (xxi) content of disclosure documents (sometimes including the business plan).

In a start-up situation, the founding Shareholders may also be asked personally to make the above representations and warranties.

Of particular concern in many transactions are the representations regarding the absence of violations by employees of obligations to prior employers or others. Particular areas of concern are covenants not to compete executed with prior employers and employee obligations not to use trade secrets of others. Trade secret obligations exist whether or not an employee signed an employment agreement with a prior employer. Claims by a prior employer can be costly to litigate, disruptive of a new Company's development, and could result in a shutdown of the Company and possibly even a suit against the investors.

In addition to representations by a Company, the investors may require detailed certificates from the founding Shareholders covering factual matters pertaining to their prior employment and obligations to others. In addition, the investors will want to be sure that a Company is properly protecting its own trade secrets as part of the normal course of business. Accordingly, the Purchase Agreement may (i) contain representations regarding the due execution of Proprietary Information Agreements and Noncompetition Agreements with the Company by present employees, (ii) require as a condition to closing that if such agreements have not already been executed, they will be executed by specific employees and (iii) require the Company to covenant that such agreements will be executed with other employees as part of the future operations.

3 | CLOSING CONDITIONS:
Usual closing conditions for start-up Company.

Comment: The closing conditions consist of the conditions to be fulfilled before the investor is obligated to close. This section of the Purchase Agreement will specify the documents to be received by the investor, other agreements to be signed, and other events that are to happen. The term sheet should identify any conditions to closing which are not standard (unless they are referred to in other parts of the term sheet).

In most venture capital financings, the investment is consummated simultaneously with the execution of the Purchase Agreement. Nonetheless, most purchase agreements are drafted as if there will be a delay between the signing of the Purchase Agreement and the closing.

Standard closing conditions include:
- Correctness of representations and warranties
- Performance of all covenants, conditions and agreements
- Receipt of officer's compliance certificate and a secretary's certificate
- Receipt of an opinion of Company counsel
- Legality of investment and effectiveness of governmental and regulatory approvals
- Satisfaction with proceedings and documents
- Purchase by all investors (or a designated percentage)
Other closing conditions sometimes required:
- Opinion of patent counsel on key patents and any trade secrets issues
- Filing of amendments to certificate of incorporation
- Adoption of amendments to by-laws
- Transfer of patents or technology to the Company
- Execution of Proprietary Information Agreements by those with access to proprietary information
- Execution of Noncompetition Agreements by key employees
- Execution of Shareholders’ Agreements by investors and Common Shareholders to provide for election of some or all board members and rights of first refusal if a Shareholder proposes to sell its stock
- Resignation of certain persons from the board of directors and election of new members
- Execution of Stock Restriction Agreement, described below, to provide for vesting of Common Stock of founding Shareholders
- Adoption of Employee Stock Purchase Plan, described below, by the board of directors
- Evidence of key person life insurance on the lives of specified key employees
- Receipt of audited financial statements
- Receipt of a “cold comfort” letter from accountants
- Execution of other important documents (e.g., license agreement, credit agreement, release of claims)

4 | COVENANTS:

- **a** Annual financial statements certified by accountants of national standing or other acceptable accountants
- **b** Quarterly and/or monthly financial comparisons
- **c** Annual budgets
- **d** Inspection rights
- **e** Observers rights
- **f** Investor rights of first refusal to purchase new securities issued

**Comment:** Covenants govern the activities of the Company subsequent to the closing. Affirmative covenants obligate the Company to take specified actions, while negative covenants prohibit the Company from taking specified actions. The covenants typically will be more limited in an equity investment, which may be mitigated if the investors have more control over the Company than in a debt transaction.

Additional standard covenants in an equity investment are as follows:
- Payment of taxes
- Maintenance of properties and leases
- Insurance on properties
- Accounts and records
- Compliance with governmental requirements
- Maintenance of corporate existence

The following negative covenants are typical of a Preferred Stock investment and are typically covered in the Preferred Stock terms (the Certificate of Designation); this is actually a set of veto rights since these actions can be taken only if the requisite percent of the holders of Preferred Stock approve:
- Change to provisions of certificate of incorporation or by-laws which are for the benefit of Preferred Shareholders
- Reclassification of Common Stock into shares having a preference or priority to, or on a parity with, Preferred Stock
- Payment of dividend or distribution on the Company Stock, or redemption or repurchase of Common Stock
- Consolidation or merger
- Sale of all or substantially all assets or acquisition of all or substantially all assets of another
- Issue additional shares of Common Stock or any other security which is on parity with the Preferred Stock.

Other typical covenants deal with:
- Preparation of budget for ensuing year
- Preparation of operating plan for ensuing three years and information on changes to plan
- Information on material adverse change
- Maintenance of key person life insurance
- Reserve sufficient Common Stock available for conversion
- Related party transactions to be at arms-length basis
- Execution of Proprietary Information Agreements by future employees
- Execution of Noncompetition Agreements by future key employees
- Documentation of inventions and filing of patents
- Management stock purchases pursuant to Employee Stock Purchase Plan; authorization of future employee participants by board of directors
- Limits on compensation
- Establishment of Audit Committee and Compensation Committee of board directors
- Use of proceeds from sale of Preferred Stock

Rights of first refusal on additional issuances of capital stock are typical in a venture capital financing. A right of first refusal will allow the investor to purchase all or any part of a future issuance. As an alternative, venture capital investors are sometimes granted contractual preemptive rights which permit them to maintain their percentage ownership in the Company.
The Founders may ask to participate in these rights, at least as long as they remain employees.

The Agreement often provides that specified covenants will terminate once a Company is sold or consummates a firm commitment public offering of a minimum size.

5 | REGISTRATION RIGHTS:
a | Two demand registrations after ________, 200_
b | Unlimited piggyback rights
c | Demand and piggyback at Company expense
d | Unlimited S-3 rights at Company expense

Comment: The securities issued by the Company will be “restricted” since they will not have been registered under the Securities Act of 1933, as amended (the “Securities Act”). They will be sold to the investors pursuant to an exemption from the registration requirements of the Securities Act which depends, among other things, on the sophistication of the investors (or their “accreditation”) and the manner in which the Company offers and sells the securities. As restricted securities, they can only be resold by the investor (i) if they are registered under the Securities Act pursuant to a registration statement filed with the SEC or (ii) they are sold in a transaction which is exempt from the registration requirements of the Securities Act.

The “demand” rights give the investor the right to require that the Company register the investor's shares.

The “piggyback” rights give the investor the right to include its shares in a registration statement prepared by the Company in connection with a primary offering of securities by the Company or a secondary offering by another security holder of the Company. Form S-3 is a short form registration statement which can be used by certain seasoned issuers.

The registration rights typically are contained in either a separate Registration Rights Agreement or in a separate section of the Purchase Agreement or Shareholders’ Agreement. Issues commonly negotiated or addressed are:

- the number of demand registrations;
- when demand can be made (i.e., can the investor require a Company to go public);
- expenses for registration;
- frequency of registrations and blackout periods following a Company registration;
- suspension of registration rights if material developments are pending;
- minimum size for demand registrations;
- inclusion of management shares;
- underwriters’ cutbacks;
- cross indemnities;
- limitations on grant of future registration rights;
- market standoff provisions; and
- transferability of registration rights.

A commonly used exemption from the registration requirements of the Securities Act is Rule 144 promulgated by the SEC. Among other things, after the Company files its first registration statement under the Securities Act, it will become subject to the public information requirements of the Securities Exchange Act of 1934. If the Company is in compliance with these requirements and the investor has held restricted securities for certain time periods, the investor may sell such securities in accordance with the provisions of Rule 144. This rule can provide a low cost and expeditious
means of disposing of restricted securities of a Company. The Purchase Agreement will often require the Company to take action necessary to make available the benefits of Rule 144.

6 | EXPENSES:
The Company will bear its own expenses and the legal fees and expenses of one special counsel for the investors.

A “cap” on legal fees will often be provided. The investors may require that the Company also pay for certain due diligence expenses, which should be understood, to avoid surprises.

Management/Employee Arrangements

1 | FOUNDERS STOCK:
The 1,600,000 shares purchased by Founders are to vest 20 percent on closing plus 2.23 percent per month thereafter, until fully vested after three years. Investors to have rights of first refusal and tag-along rights.

2 | EMPLOYEE STOCK PURCHASES:
The 400,000 shares to be reserved for issuance to employees other than Founders are to vest 50 percent after two years plus 2.08 percent per month thereafter until fully vested after 24 more months.

Comment: The above arrangements are a commonly used means of allocating and restricting Common Stock to be issued to Founders and additional key employees. Subject to certain tax and accounting considerations, it may be possible to sell Common Stock to employees, subject to vesting, at a discount from the Preferred Stock price. The amount of stock which vests can be a function of the length of time the employee works or the achievement of certain milestones; if an employee leaves before full vesting, the Company may purchase the unvested stock at a price equal to the original purchase price. The Founders and other employees may be required to sign a “Stock Restriction Agreement” to provide for these restrictions on transfer. Stock Restriction Agreements also may often provide for no vesting for a specified period (and full Company purchase rights) in the event the employee is terminated for cause. The nonvested stock may be placed in escrow.

The holders of restricted stock should consider filing a “Section 83(b) election” with the IRS to avoid taxation of each installment as it vests, based on the then fair market value.

The Founders may want a portion of their stock to be fully vested from the outset. They also may want their stock to vest fully in the event of a change of control of the Company or an IPO. There are various issues associated with this, including a potential adverse impact on the consideration per share that will be paid to the investors upon a change in control.

In addition, the above terms provide that the Founders’ stock is to be subject to a right of first refusal of the investors; thus, any vested stock which a Founder wishes to sell will have to be offered to the investors. This right is often obtained with respect to all stock sold to employees. An alternative to this is a right of first offer to the investors, whereby the selling Founder must name a price but need not have an offer from a third party. These “tag-along” rights give the investors the option to participate in any sale by a Founder, rather than acquiring the Founder’s stock.

Nonbinding Effect
This summary of terms is for discussion purposes only. It is not all inclusive. Neither party shall be legally bound by reason of this summary of terms nor shall any rights or liabilities arise as a result of its delivery.
Hypothetical Valuation of SoftTouch, Inc.

Presented to the MIT Enterprise Forum of Connecticut
The following example demonstrates a hypothetical valuation of SoftTouch, Inc. during various rounds of investment. It is based on the assumption that the company will have after-tax income of $2,500,000 in the fifth year after the Round I Financing; based on a price/earnings ratio of 15:1 for similar companies, the company’s valuation at the end of the fifth year would be $37,500,000.

Note that the stock option plan reserve is included as part of the “pre-money shares” outstanding.

### Round 1 of Investment

**CALCULATIONS OF NEW SHARES TO BE ISSUED**

- $1,000,000 total investment
- 58% desired annual rate of return
- $9,846,580 desired value of New Shares in year 5

\[
\$9,846,580 = 26\% \text{ of projected shares outstanding in year 5}
\]

- $37,500,000

**PRO FORMA CAPITALIZATION**

<table>
<thead>
<tr>
<th>Preferred Stock</th>
<th>Common Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series A</td>
<td>Founders</td>
</tr>
<tr>
<td>260,000 shares</td>
<td>360,000 shares</td>
</tr>
<tr>
<td>36%</td>
<td>49%</td>
</tr>
<tr>
<td></td>
<td>Stock Option Plan</td>
</tr>
<tr>
<td></td>
<td>110,000 shares</td>
</tr>
<tr>
<td></td>
<td>15%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>Fully Diluted</td>
<td>Fully Diluted</td>
</tr>
<tr>
<td>730,000 shares</td>
<td>860,000 shares</td>
</tr>
<tr>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**VALUATION**

- Price Per New Share: $3.85
- Post-Financing Valuation: $2,810,500.00
- Pre-Money Valuation: $1,810,500.00

### Round 2 of Investment

**CALCULATION**

- $2,500,000 additional investment after one year
- 25% desired annual rate of return
- $4,882,812 desired value of New Shares in year 5

\[
\$4,882,812 = 13\% \text{ of projected shares outstanding in year 5}
\]

- $37,500,000

**PRO FORMA CAPITALIZATION**

<table>
<thead>
<tr>
<th>Preferred Stock</th>
<th>Common Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series A</td>
<td>Founders</td>
</tr>
<tr>
<td>260,000 shares</td>
<td>360,000 shares</td>
</tr>
<tr>
<td>30%</td>
<td>42%</td>
</tr>
<tr>
<td>Series B</td>
<td>Stock Option Plan</td>
</tr>
<tr>
<td>130,000 shares</td>
<td>110,000 shares</td>
</tr>
<tr>
<td>15%</td>
<td>13%</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td></td>
<td>Fully Diluted</td>
</tr>
<tr>
<td></td>
<td>Fully Diluted</td>
</tr>
<tr>
<td></td>
<td>860,000 shares</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

**VALUATION**

- Price Per New Share: $19.23
- Post-Financing Valuation: $16,537,800.00
- Pre-Money Valuation: $14,037,800.00
Hypothetical Valuation
continued

Round 3 of Investment

**CALCULATION**

- $5,000,000 investment in year four
- 15% desired annual rate of return
- $5,750,000 desired value of New Shares in year 5

$5,750,000 = 15% of projected shares outstanding in year 5

$37,500,000

**CAPITALIZATION**

**Preferred Stock**

<table>
<thead>
<tr>
<th>Series</th>
<th>Shares</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series A</td>
<td>260,000</td>
<td>26%</td>
</tr>
<tr>
<td>Series B</td>
<td>130,000</td>
<td>13%</td>
</tr>
<tr>
<td>Series C</td>
<td>150,000</td>
<td>15%</td>
</tr>
</tbody>
</table>

**Common Stock**

| Founders  | 360,000  | 36%        |
| Stock Option Plan | 100,000  | 10%        |

**Total** Fully Diluted 1,000,000 shares 100%

New Stock Option Plan to be adopted

**VALUATION**

- Price Per New Share: $33.33
- Post-Financing Valuation: $33,333,333.00
- Pre-Money Valuation: $28,333,333.00

Value of Investments in Year 5

<table>
<thead>
<tr>
<th>Investment</th>
<th>Shares</th>
<th>Cost/Share</th>
<th>Year 5 Value/Share</th>
<th>Year 5 Value of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series A Preferred</td>
<td>$1,000,000</td>
<td>260,000</td>
<td>$3.85</td>
<td>$37.50</td>
</tr>
<tr>
<td>Series B Preferred</td>
<td>1,500,000</td>
<td>130,000</td>
<td>19.23</td>
<td>37.50</td>
</tr>
<tr>
<td>Series C Preferred</td>
<td>5,000,000</td>
<td>150,000</td>
<td>33.33</td>
<td>37.50</td>
</tr>
<tr>
<td>Founders</td>
<td>Nominal</td>
<td>360,000</td>
<td>—</td>
<td>37.50</td>
</tr>
<tr>
<td>Employee Options</td>
<td>100,000</td>
<td>—</td>
<td>37.50</td>
<td>3,750,000</td>
</tr>
</tbody>
</table>

$37,500,000

—Frank J. Marco, Esq.
Use of Equity-Based Compensation

Use of Equity-Based Compensation

Types of Plans

Stock Options
Non-Qualified and Incentive Stock Options
Exercise and Incentive Stock Options
Vesting of Installments
  *Straight Line/Cliff*

Stock Appreciation Rights

Phantom Stock

Restricted Stock
Vesting

Key Considerations

Tax Implications
To Company-Deduction
To Grantee-Income
Amount And Timing
Long Term Capital Gain

Accounting
Charge To Earnings Of Company
Measurement Date For Options
  *Fixed or Variable*
Time Accelerated Restricted Stock Award Plan ("TARSAP")

Securities
"Restricted Stock"
Rule 144 Holding Period
Rule 701

Cash Flow
Cash Cost To Company
Cash Cost To Grantee

Risk To Grantee

Dilution

Emotion
Positive Features Of Stock Ownership

Minority Stockholders

Importance of Early Issuances

"Founders’ Stock"

Later Stage Pricing

Common Scheme
Founders’ Stock For Initial Owners
Non-Qualified Stock Options ("Nqso")
Tax Bonus
Use Of Preferred Stock

Structural Issues

Keep Powder Dry
Vesting
Acceleration of Vesting on change of control
Call of Vested Shares
  *Termination, Death*
Calculation of F.M.V.
Key Person Insurance

Rights of Refusal

Maintain Flexibility For Raising

Future Capital/Sale Of Business
Avoid Need For Unanimity
Mandatory
Conversion/Exercise
Avoid Holdout Holdups

Position for "Play or Pay Financing"

Recapture Stock of Former Employees
Fairness

Repricing of Options

Originally presented to the MIT Enterprise Forum of Connecticut at its seminar entitled "Building a Business—Strategies, Structure and Financing"
## Use of Equity-Based Compensation

### Stock Options

#### NQSO

<table>
<thead>
<tr>
<th>CONSIDERATION</th>
<th>GRANT</th>
<th>EXERCISE</th>
<th>SALE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Participant receives an option to purchase stock at designated price, which should be based on fair market value (“f.m.v.”) on the grant date. Not limited to employees (for example, consultants may receive NQSOs). Option may vest (i.e., become exercisable) over time.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company (deduction)</td>
<td>—</td>
<td>Spread between f.m.v. and exercise price</td>
<td>—</td>
</tr>
<tr>
<td>Grantee (income)</td>
<td>—</td>
<td>Spread between f.m.v. and exercise price (ordinary income)</td>
<td>Spread between sales price and f.m.v. on exercise date (L.T. capital gain if held for 12 months)</td>
</tr>
<tr>
<td><strong>Accounting</strong> (expense)</td>
<td>Annually over vesting period based on fair value on grant date of options expected to vest</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (negative)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Grantee</td>
<td>—</td>
<td>exercise price and taxes</td>
<td>taxes</td>
</tr>
<tr>
<td><strong>Dilution</strong></td>
<td></td>
<td>yes</td>
<td>—</td>
</tr>
<tr>
<td><strong>Emotion</strong></td>
<td></td>
<td>yes</td>
<td>—</td>
</tr>
<tr>
<td><strong>Minority Stockholders</strong></td>
<td></td>
<td>yes</td>
<td>—</td>
</tr>
</tbody>
</table>
## Stock Options

### ISO

<table>
<thead>
<tr>
<th>CONSIDERATION</th>
<th>GRANT</th>
<th>EXERCISE</th>
<th>SALE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Participants receive an option to purchase stock at f.m.v. on date of grant (110% of f.m.v. for 10% shareholders). Option may vest (i.e., become exercisable) over time. ISOs may only be issued to employees. Other requirements of the Internal Revenue Code apply.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company (deduction)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Grantee (income)</td>
<td>—</td>
<td>No regular tax, but possible alternative minimum tax (&quot;AMT&quot;) on spread between f.m.v. and exercise price</td>
<td>Spread between sales price and exercise price (cap. gain unless a &quot;disqualifying disposition&quot;)</td>
</tr>
<tr>
<td><strong>Accounting (expense)</strong></td>
<td>Annually over vesting period based on fair value on grant date of options expected to vest</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Cash flow (negative)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Grantee</td>
<td>—</td>
<td>exercise price and possible AMT taxes</td>
<td>—</td>
</tr>
<tr>
<td><strong>Dilution</strong></td>
<td>—</td>
<td>yes</td>
<td>—</td>
</tr>
<tr>
<td><strong>Emotion</strong></td>
<td>—</td>
<td>yes</td>
<td>taxes</td>
</tr>
<tr>
<td><strong>Minority Stockholders</strong></td>
<td>—</td>
<td>yes</td>
<td>—</td>
</tr>
</tbody>
</table>
**Use of Equity-Based Compensation**

### Phantom Stock

<table>
<thead>
<tr>
<th>CONSIDERATION</th>
<th>GRANT</th>
<th>EXERCISE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Participant receives units of “phantom” stock, and on exercise, receives the full value of each unit based on f.m.v. of stock. Paid in cash or stock.</td>
<td></td>
</tr>
<tr>
<td><strong>Tax</strong>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company (deduction)</td>
<td>—</td>
<td>spread</td>
</tr>
<tr>
<td>Grantee (income)</td>
<td>—</td>
<td>spread (ord. income)</td>
</tr>
<tr>
<td><strong>Accounting</strong> (expense)</td>
<td>annually over vesting period based on fair value on grant date of rights expected to vest (fair value redetermined annually if cash to be paid)</td>
<td>—</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (negative)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>—</td>
<td>yes (assuming cash paid)</td>
</tr>
<tr>
<td>Grantee</td>
<td>—</td>
<td>taxes</td>
</tr>
<tr>
<td><strong>Dilution</strong></td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Emotion</strong></td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Minority Stockholder</strong></td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

*companies and grantees should also consider any potential tax implications under the new final regulations issued under section 409A.*
# Restricted Stock

<table>
<thead>
<tr>
<th>CONSIDERATION</th>
<th>GRANT</th>
<th>VESTING</th>
<th>SALE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Participant receives an award of stock or purchases the stock, subject to vesting (and forfeiture).</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company (deduction)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>–if 83(b) election</td>
<td>only if price &lt; f.m.v.</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>–if no 83(b) election</td>
<td>—</td>
<td>spread between price and f.m.v.</td>
<td>—</td>
</tr>
<tr>
<td>Grantee (income)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>–if 83(b) election</td>
<td>only if price &lt; f.m.v. (ord. inc.)</td>
<td>—</td>
<td>spread between purchase price and sales price (cap. gain)</td>
</tr>
<tr>
<td>–if no 83(b) election</td>
<td>—</td>
<td>spread between price and f.m.v. (ord. inc.)</td>
<td>spread between tax basis and sales price (cap. gain)</td>
</tr>
<tr>
<td><strong>Accounting (expense)</strong></td>
<td>annually over vesting period based on fair value of shares on grant date</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Cash flow (negative)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>purchase price (if any)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Grantee</td>
<td>—</td>
<td>taxes (if no 83 (b) election)</td>
<td>—</td>
</tr>
<tr>
<td><strong>Dilution</strong></td>
<td>yes</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Emotion</strong></td>
<td>yes</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Minority Stockholder</strong></td>
<td>yes</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>
## Use of Equity-Based Compensation

### Life Cycle Illustration

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
<th>Investor Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/30/07</td>
<td>Initial Capitalization</td>
<td>Founders A&amp;B: 100,000 shs. each Common → $.01/share.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vesting: 25% after 1 year, 2.083%/month thereafter.</td>
</tr>
<tr>
<td>1/10/08</td>
<td>First Vesting Date</td>
<td>f.m.v. = $.20/share</td>
</tr>
<tr>
<td>1/10/09</td>
<td>Round 2 Investors</td>
<td>f.m.v. = $.60/share</td>
</tr>
<tr>
<td>2/10/09</td>
<td>Option Exercise</td>
<td>A: difference between purchase price and sale price (cap. gain)</td>
</tr>
<tr>
<td>1/10/14</td>
<td>Sale Date</td>
<td>B: difference between tax basis and sale price (cap. gain)</td>
</tr>
<tr>
<td></td>
<td>A files 83(b) election</td>
<td>A: no tax</td>
</tr>
<tr>
<td></td>
<td>B: does not file</td>
<td>B: Tax on 25,000 x $.19 ($4,750) and monthly thereafter (ord. inc.)</td>
</tr>
<tr>
<td></td>
<td>Investor: 120,000 shares of A Preferred @ $1.00/sh.</td>
<td>Investor: 100,000 shares of B Preferred @ $3.00/sh.</td>
</tr>
<tr>
<td></td>
<td>Option Plan: Employee #1</td>
<td>Option Plan: Employee #1 6,000 shares Common NQSOs @ $.20/share vesting 25%/year</td>
</tr>
<tr>
<td></td>
<td>Employee #2</td>
<td>Employee #2: 6,000 shares Common ISOs @ $.20/share vesting 25%/year</td>
</tr>
<tr>
<td></td>
<td>#1: 1,500 x $.20 ($300) ex. price Taxable: 1,500 x ($60–20) = $600.00 (ord. inc.)</td>
<td>Difference between tax basis and sale price (cap. gain)</td>
</tr>
<tr>
<td></td>
<td>#2: Same ex. price. No tax (possible AMT)</td>
<td>Differences between exercise price and sale price (cap. gain)</td>
</tr>
</tbody>
</table>
Roadmap to Success
A presentation by Frank J. Marco and Paul A. Hughes
Roadmap to Success
A Presentation by Frank J. Marco and Paul A. Hughes

Legal Preparation Prior to IPO

- Review employee benefit plans
  - Option plans/Rule 16b-3 compliance and tax issues
  - Cheap stock issues
  - Blue Sky law compliance (if not listing on Nasdaq NMS, AMEX, or similar exchange)

Legal Preparation Prior to IPO

- Ongoing process from start-up — to position the company
  - Sunset provisions
  - Automatic conversion
  - Less than unanimity
  - Staff issues
- Review articles of incorporation and bylaws

Legal Preparation Prior to IPO

- Resolve any outstanding defaults/disputes
- Review agreements
- Review management arrangements and related party transactions

Legal Preparation Prior to IPO

- Review/simplify corporate structure
- Review corporate records to assure completeness
  - Minute books
  - Stock issuances and option grants

- Personal matters
  - Estate planning
  - Employment agreements
- Are you ready full disclosure?
- Remain static
- Cash in the bank — Limits on Stock Sales
Due Diligence – The Process

- Performed by underwriters, company counsel and underwriters’ counsel
- Keep copies of all documents supplied
- Review of principal agreements

Due Diligence – The Process

- What is reviewed:
  - Industry data
  - Obligations and liabilities
  - Shareholders
- Directors and officer questionnaires
- Securities law liability – due diligence defense

Due Diligence – The Process

- Who does it?
- Obtain necessary consents
- Meetings with managers/plant visits
- Collect exhibits to registration statement

Structure of the Offering

- Valuation and price range
- Need for stock split
- Underwriting agreement
  - Time when underwriting is committed
  - Best efforts/firm commitment
  - Agreement among underwriters

Due Diligence – The Process

- What is reviewed:
  - Background information
  - Operational data
  - Financial data
  - Management

Structure of the Offering

- Securities offered
- Primary/secondary shares
- Lock-up agreements
The Registration Process – An Overview

- Planning
  - Legal preparation and timing
  - Selection of underwriters
- Due diligence
- Drafting of registration statement
- Filing with SEC

The Registration Statement

- The Registration form
  - Form S-1 – no limitations on size of company or offering
  - Form SB-1 and SB-2 <$25 million in revenue
- Regulation S-K and Regulation S-X

The Registration Process – An Overview

- Listing application with Nasdaq or an exchange
- Effectiveness
- Closing

The Registration Statement

- Dual Role of the Prospectus
  - Investor protection
  - Sales Document – tells the Company’s story and why investors should be interested in the Company’s stock

The Registration Statement

- Some General Principals
  - Plain English
  - All material information (including material contingencies)
  - No half-truths
  - Statements challenged for support

Venture Start-Up Kit
Roadmap to Success

continued

The Registration Statement

- Contents of the prospectus (some highlights)
  - Risk factors
  - "Forward looking information" (safe harbor not available for IPO)
  - MD&A

Publicity Before and During Offering

- Before filing with SEC – "Gun Jumping"
  - Do not comment on questions regarding a potential offering
  - Keep planned offering on need-to-know basis
  - Avoid publicity that promotes the company itself

The Registration Statement

- Contents of the prospectus (some highlights)
  - Business description
  - Management
  - Executive compensation
  - Insider transactions

Publicity Before and During Offering

- Before filing with SEC – "Gun Jumping"
  - Avoid public statement regarding financial performance
  - Continue regular product advertising and promotion

The Registration Statement

- Contents of the prospectus (some highlights)
  - Underwriting
  - Financial statement

Publicity Before and During Offering

- Between filing and SEC effectiveness
  - Distribute preliminary prospectus ("red herring")
  - Do not distribute any written materials with preliminary prospectus
Publicity Before and During Offering

- Between filing with SEC effectiveness
  - Avoid selective disclosure not generally available to all the preliminary prospectus
  - Continue to avoid publicity that promotes the company itself

Use of the Internet for

- Offerings
- Trading
- Delivery of prospectuses
- Road show presentation

Publicity Before and During Offering

- Between filing and SEC effectiveness
  - Continue to avoid public statements regarding financial performance
  - Continue regular product advertising and promotion

Public Company Issues for Board of Directors

- Composition of the Board
- Indemnification and insurance
- Employment agreements – golden parachutes

Publicity Before and During Offering

- After SEC effectiveness through the end of the "quiet period"
  - Distribute final prospectus
  - May distribute other written materials accompanying or proceeding final prospectus
  - "Sticker" prospectus to disclose material post-effective developments

Public Company Issues for Board of Directors

- Anti-takeover devices
  - Staggered board
  - "Poison pills" and "blank check"
  - Supermajority votes
  - Stockholder votes only at meeting
Public Company Issues for Board of Directors

• Obtain any required stockholder votes before IPO

Effects of Being a Public Company

• Increased administrative, legal and accounting costs
• Compliance with the reporting requirements of the Securities Exchange Act of 1934
  – Safe Harbor for forward looking statements

• Regulation of stock transfers by officers, directors, and other insiders
  – Forms 3, 4 and 5
  – Restrictive trading policies for high level personnel; “windows” and “blackouts”
The Process

- Preparation
- Due Diligence
- Letter of Intent
- Negotiation of Final Agreements and closing

Due Diligence - Purpose

- In Depth Analysis and Understanding of the Business
  - Purchase price
  - Deal Structure
  - Identify Necessary Consents and Approvals

Preparation

- Assemble the Team
  - Management
  - Financial
  - Legal
  - Investment Bankers
- Define Roles
- Anticipate issues

Due Diligence - Confidentiality

- Confidentiality Agreements
  - When
  - Why
  - Issues When Competitors Involved

Due Diligence

- Purpose
- Confidentiality
- Scope of Review

Due Diligence – Scope of Legal Review

- Organizational Documents, Corporate Records and Stock Transfer Records
- Material Agreements
- Debt Obligations
- Title to property, Including Intellectual Property
- Tax Matters
- Litigation
- Environmental matters
- Compliance with Law
Roadmap to Success

continued

Letter of Intent – Pros and Cons

• Pros
  – Framework to Guide parties and Advisors Through Deal
  – Tangible Evidence of Key Terms for Third parties
  – Investors
  – Regulators

Letter of Intent – Pros and Cons

• Cons
  – Delay
  – Expense
  – May Force Early Disclosure
  – Litigation