

# PREPARING YOUR STARTUP FOR INVESTMENT

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**TWIN CITIES**  
**STARTUP WEEK**



# Preparing Your Startup for Investment



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# How to Prepare your Startup for Investment

- > Form a Company
- > Maintain Records
- > Identify & Protect IP
- > Build a Team
- > Raise Money



# **Forming a Company and Maintaining Records**

Stephen P. Charbonnet

# Business Entity Selection

- > Purpose
- > Types
- > Corporations
- > Limited Liability Companies
- > When & Where



# Purpose of Creating an Entity for Business

- > Limit liability solely to contributed capital or debts personally guaranteed
- > Facilitate sharing ownership among stakeholders

# Entity Selection

## > Corporations

### > C corporation

- > Any type of owner is permitted
- > Double income taxation

### > S corporation

- > Only individuals and revocable trusts can be stockholders
- > Only stockholders pay the income taxes

### > B (or benefit) corporation

- > Any type of owner
- > Can be taxed either as C or S corporation
- > Company not limited to managing solely for stockholder benefit

# Entity Selection

- > Limited Liability Company
  - > Any type of owner
  - > Single level of income taxation
  - > Not preferred by professional investors – Why?
    - > Startups fail to timely distribute K-1s at year end
    - > Investors may need to file multiple state income tax returns
    - > Offshore investors may need to file US income tax returns



# What to Do?

- > If you are an LLC, stay an LLC until investors require conversion to a C corporation
- > If you are forming the company and you plan to raise outside capital in the first year, form a C corporation
- > If you don't plan to raise outside capital in the first year, form an LLC and plan to convert to a C corporation when investors require

# When and Where to Form Your Company

- > Form the company when you first need an agreement with an outside party
  - > Bringing on co-founders
  - > Filing patents or trademarks
  - > Entering into employment or independent contractor arrangements
- > Plan on forming your company in Delaware
  - > Preferred by investors
  - > Added costs as compared to Minnesota entities

# Maintain Records

- > Business/Strategic Plans
- > Written Actions and Resolutions
- > Agreements/ Contracts
- > Financials/ KPI Reports
- > Intellectual Property Registration
- > Marketing Materials
- > Customer Lists
- > Insurance
- > Compensation Info
- > Tax Documents
- > Capitalization Table



# **Protecting Intellectual Property**

Pamela A. Curran

# Identify & Protect IP

- > Patents
- > Copyrights
- > Trademarks
- > Trade Secrets
- > Domain Names
- > Confidentiality Agreements

# Know the Difference: Patents, Trademarks, Copyrights

| Patents  | Trademarks   | Copyrights  |
|--|--|---|
| <p>Right to exclude others from using your invention.</p>  | <p>Right to exclude others from using your name.</p>  | <p>Right to exclude others from copying your work of authorship.</p>  |

# Data Privacy and Cybersecurity

- > “Personally Identifiable Information”
  - > Name, address, email address, phone number, social security number, etc.
- > Patchwork of federal and state laws
- > GDPR
- > Must haves
  - > Privacy Policy
  - > Terms of Use



# **Building the Team: Employment Matters**

Daniel L. Lowin



# Employees v. Independent Contractors

## > Employee

- > Told when and where to work
- > Told how to do the job
- > Established work hours
- > Training
- > Paid at regular intervals
- > “At-will” right to quit

## > Independent Contractors

- > Perform services under a contract
- > Maintain a separate business with opportunity for profit and loss
- > Offers services to general public
- > Control own hours of employment
- > Supply own equipment, materials, and tools
- > Not integral to business

# Restrictive Covenants: Non-Competition / Non-solicitation

- > Reference in any employment offer letter
- > Consider
  - > Type of employee
  - > Geographic area and time period of restriction
  - > Adequate consideration
- > Choice of Law/Venue Matters
  - > Some states will not enforce

# Invention Assignments

- > Cover both employees and independent contractors
- > Get signed at beginning of relationship and pay for it
- > All rights transferred (some exceptions)
- > Exclude inventions created outside scope of relationship



# Using Equity Compensation

Jeffrey C. Robbins

# Equity Incentives

- > Allows employees, consultants and directors to share in upside of business growth
- > Aligns business objectives
- > Can act as a “golden handcuff” to help in retention of key personnel
- > May allow income (and tax) deferral to later date
- > May convert ordinary income into capital gains (taxed at lower rates)

# Equity Incentives

- > For Corporations
  - > Incentive Stock Options
  - > Non-Qualified Options
  - > Restricted Stock
- > For LLCs
  - > Profits Interests
- > Vesting and Reverse Vesting

# Incentive Stock Options

- > No tax on exercise; capital gains if stock acquired on exercise is held for a year
- > Written plan approved by board and stockholders
- > \$100,000 vesting in any calendar year
- > 10 year max term
- > Grant price at fair market value
- > Exercise within 3 months on termination (1 year for death/disability)

# Non-Qualified Stock Options

- > Ordinary income tax on exercise; capital gains on future gain after that
- > No written plan required; just approved by board
- > No cap on dollar value vesting in any calendar year
- > No max term
- > Grant price at fair market value
- > Exercise after termination/death/disability as negotiated



# Restricted Stock

- > Represents an actual issuance of shares
- > 83(b) election

# Profits Interest

- > Represents a LLC membership interest participating in appreciation of company value from grant date

# Vesting

- > Four years most common
- > 25% per year
- > 1 year cliff for 25%; 1/36th per month thereafter

# Reverse Vesting

- > Venture investors often require founder to agree to give up equity if they don't remain with the company, usually over four years



# **Raising Startup Capital**

Andrew M. Tataryn and  
Zachary J. Robins

# What Security Do You Offer?

- > Common Stock
- > Preferred Stock
- > Convertible Debt
- > SAFEs

# Securities Laws Apply

- > If you sell securities in your company, you either need to register the offering with the SEC or the offering must be exempt from registration
- > Each state also has its own rules about what kinds of offerings can occur without registration

# Rule 506 Exempt Offerings

## > Two Choices

- > Rule 506(b) – Prohibits general solicitation to market your securities offering
  - > Rule 506(c) – Allows general solicitation to market your securities offering
- > “General Solicitation” includes any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media, or broadcast over TV or radio or the internet, and any seminar or meeting where attendees have been invited by general solicitation





# Rule 506(b): Traditional Private Placement

- > Unlimited Dollar Amount
- > Unlimited Accredited Investors
- > Maximum of 35 Non-Accredited Investors
- > No Public Solicitation of Investors
- > Potentially No Mandated Disclosure (BUT risk factor disclosure is important)
- > Only a Notice Filing with SEC and States

# The Accredited Investor

- > Net worth > \$1,000,000 (excluding primary residence)
- > Annual Individual Income > \$200,000
- > Annual Joint Income > \$300,000

# Rule 506(c): The New World Order

- > Allows general solicitation but only to accredited investors
- > Must take reasonable steps to verify status

# Nationwide Equity Crowdfunding



**JOBS ACT**  
JUMPSTART OUR BUSINESS STARTUPS

# Four Things to Know

## > Offering Limit

- > \$1.07 million in 12 months

## > Investor Annual Limits for All Crowdfunding Investments

- > Annual income/net worth < \$107,000

- > Limit is greater of \$2,200 or 5% of the lesser of annual income/net worth

- > Annual income/net worth  $\geq$  \$107,000

- > Limit is lesser of \$107,000 or 10% of the lesser of annual income/net worth

# Four Things to Know

## > Use of Funding Portals and Brokers

- > Companies must sell and communicate with investors through a portal or broker registered with the SEC and FINRA
  - > Arranges handling of funds for the company
  - > Posts company disclosure information

## > Company Requirements

- > Form C Offering Statement disclosure with MD&A discussion and annual reporting
- > Financial information
  - > Tax return/financials  $\leq$  \$107,000
  - > Review financials  $\leq$  \$535,000
  - > Audited financials  $>$  \$535,000 (except first time reviewed financials)

# Crowdfunding by the Numbers

- > 1,139 offerings / ~740 reached minimum
- > \$145,000,000+ total raised
- > Over 148,000 investors
- > Median / average closing - \$170,000 / \$227,000
- > 41% common or preferred / 22% debt / 25% SAFEs

# State-Based Crowdfunding





# Four Things to Know



## > Offering Limit

- > \$1 million in 12 months (\$2 million with audited or reviewed financials; \$5 million with SCOR)

## > Investor Limits

- > \$10,000 per company (unless an accredited investor)
- > Must be a Minnesota resident

# Four Things to Know



## > Funding Portals

- > Companies must sell through a portal registered with the State (5)
  - > Handles funds for the company
  - > Posts company disclosure information
  - > Company can register as its own portal

## > Company Requirements

- > Headquartered in Minnesota
- > Disclosure, but no annual reporting
- > Balance sheet and income statement
- > Only can direct investors to the portal

# Early Stage Valuation

- > For whatever is the right amount of capital, you will give away 25-33% of your company

# Networking Events

- > Your presentation may constitute public solicitation
- > Talk about your business and not about financing
- > Follow-up only with investor prospects that you have verified are accredited investors

# Networking Events

- > Quarterly networking event for investors



ANGELPOLLENATION

CONNECTING MINNESOTA INVESTORS

# YOUR QUESTIONS?

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