

This is **Volume II** of **VI**
in the Foley & Lardner
Emerging Companies Primer Series

PRIMER ON EARLY STAGE FINANCING

Prepared by

Joseph P. Hildebrandt, Esq.
Foley & Lardner
150 East Gilman Street
Madison, Wisconsin 53703
608/ 258-4232
jhildebrandt@foleylaw.com

Note: This is a brief summary
and is not to be relied upon
for legal advice.

Preface

This Primer has been written assuming the reader has read the “Primer on Selection of a Business Entity,” the “Primer on Federal and Wisconsin Securities Laws” and the “Primer on How To Offer and Sell Securities” also prepared by Foley & Lardner in connection with this Primer series, or at least has them available for reference, and has determined to proceed with the financing of the enterprise.

OTHER FOLEY & LARDNER PRIMERS

Foley & Lardner has several volumes in this Primer series that are designed for non-lawyers such as founders of start-ups and emerging companies, other executives and “Angel” investors. The entire series of Wisconsin Primers is listed below:

- I. Primer on Selection of a Business Entity
- II. Primer on Early Stage Financing
- III. Primer on Intellectual Property
- IV. Primer on Federal and Wisconsin Securities Laws
- V. Primer on How to Offer and Sell Securities
- VI. Primer on Use of the Internet to Sell Securities

The Primers are designed for use in Wisconsin, but also provide information to assist readers in other states.

Mr. Hildebrandt would like to acknowledge the initial contribution to this Primer from William D. Evers of the San Francisco office of Foley & Lardner, and the input from attorneys Leonard S. Sosnowski, Christopher S. Berry, Paul T. Wrycha, and Tracy L. Staidl of the Madison office of Foley & Lardner’s Emerging Growth Companies/Venture Capital Practice Group.

TABLE OF CONTENTS

	<u>Page</u>
I. THE SETTING – A TYPICAL SCENARIO	1
II. FORMATION OF THE BUSINESS	1
III. THE FOUNDER’S STOCK, ISOs AND NON-STATUTORY STOCK OPTIONS	2
IV. PIE-SLICING	4
V. THE FUND RAISING.....	5
VI. SUMMARY	6

I. THE SETTING – A TYPICAL SCENARIO

- The entrepreneur, or principal “Founder,” has toiled long and diligently for almost a year; has forgone salary and invested \$25,000 in developing a written business plan, developing schematics for a new type of software, and created and attracted the beginnings of a management team. The Founder is seeking an additional \$1 million, at a minimum, in financing in this seed stage.
- The Founder wishes to maintain control of the company, provide handsome incentive stock options for the management team and avoid high taxes to the fullest extent possible.
- The Founder believes that he or she deserves 80% of the equity because of the transfer of the business ideas and intellectual property rights and the effort on his or her part in advancing to this critical stage of development. Sober reflection yields a target of 70% equity ownership by the Founder, with a pre-money value of \$2 million.
- The business entity has not been formed, or was only recently formed.
- The Founder ultimately hopes to take the company public and sell all of his or her interests in connection with the initial public offering (IPO) or sell the business to a company in a dominant industry position, each a so-called “exit plan.”
- The business is located in Wisconsin.

II. FORMATION OF THE BUSINESS

Please see the “Primer on Selection of a Business Entity” for a more detailed discussion of the information that follows.

As the Founder’s exit plan is to go public or sell the company, the Founder decides to use a “C”-type corporation. A limited liability company (LLC), however, may be the initial entity to select for the start-up and development stages of the enterprise. This is particularly true if the IPO is well down the road and the Founder or angel investors wish to enjoy the tax benefit of the flow-through of initial losses. The LLC can easily be converted to a “C” corporation a reasonable time before the IPO. However, some venture capital funds favor “C” corporation status when they get involved for its simplicity, because they do not want to recognize the early losses and because their partners may be pension plans or other non-profit investors. A “C” corporation has the advantage of its operating losses being carried forward to offset future profits. However, the value of the carryforward can be significantly diluted with the later admission of new shareholders or upon a merger or sale of the business.

Assuming a “C” corporation is selected, the next issue to resolve is the state in which to incorporate. This is an issue with many legal and practical ramifications.

Venture capital firms and investment bankers sometimes favor Delaware. The author believes this is based to a large extent on tradition. There is a perceived view from out-

of-state firms that Wisconsin is somehow anti-business and Delaware is not. Delaware does have some advantages: there are fewer situations in which dissenters' rights apply and Delaware has Chancery Courts which are widely-recognized as the nation's preeminent forum for resolving business and corporate affairs disputes. However, other than the practical consideration that Delaware is favored by the financial community, there appears to be little justification for a Wisconsin-based and primarily-owned corporation to incorporate in Delaware.

If the corporation were to incorporate in Delaware, it would have to qualify to do business in Wisconsin and pay taxes just as if it were a Wisconsin corporation. It would have to pay franchise taxes in Delaware and the corporation will have to file annual reports with annual fees in two states instead of one. Delaware franchise taxes are based on formulas involving par value, which causes Delaware corporations to have the par value on both the common and preferred stock typically set at an extremely low amount, such as \$.001.

On balance, the author believes the best route is to form a Wisconsin corporation and then, if, the venture capital firm or investment banker for later stage rounds insists on a Delaware corporation, simply re-incorporate in Delaware, a rather simple and inexpensive procedure.

Presume that the corporation elects to incorporate in Wisconsin. A concurrent issue is the capital structure of the corporation: how many shares of stock to authorize and the type of shares to authorize. In Wisconsin, a corporation must pay a \$100 flat fee to incorporate no matter how many shares are authorized. Wisconsin does not have its filing fee based on par value and, in fact, has no requirement of par value; however, par value can be used to avoid higher taxes in other states. Under the Wisconsin Business Corporations Law, the corporation's Board of Directors may thereafter issue series of preferred stock without having to obtain shareholder approval for the series by filing Articles of Amendment with the Wisconsin Department of Financial Institutions (DFI), which specify the preferences, limitations and relative rights of the preferred stock.

So, we form the Wisconsin corporation and authorize 10,000,000 shares, a majority of which are shares of common stock and the remainder of which are shares of preferred stock. Filing fees are \$100 for Articles of Incorporation, expedited service is \$25 (saves weeks of time), and the Corporate Minute Book, Corporate Seal (if desired) and Common and Preferred Stock Certificates are approximately \$100.

III. THE FOUNDER'S STOCK, ISOs AND NON-STATUTORY STOCK OPTIONS

The Founder (or Founders) wishes to retain control. Here is a huge potential tax trap: if the Founder receives common stock (not preferred — see below) for his or her services in establishing the company (and not for "property" such as initial materials or intellectual property), the value of the stock may be taxable to the Founder at ordinary income tax rates, which can be double or more of capital gain rates.

In our example, the Founder invests \$25,000 in start-up costs. He or she has not taken any deduction of business expense from income. Under these circumstances, there can be a tax-free transfer of all assets created in exchange for, say, 70% of the stock to be outstanding after the seed money is received. At the time of the transfer, the entity has value only as a concept, presumably with no business “proof of concept” and, perhaps, no final technical proof of concept (i.e., one would contend the company has little or no value). This exchange should take place as close to incorporation of the corporation as possible, preferably within a day or two after formation.

Once the exchange is made, some time should elapse (the longer the better) before the investor money is received. This is because the investor money will set the fair market value of the stock and, if the Founder paid \$.01 per share and the investor the next day paid \$1.00 per share, even for Preferred Stock, the IRS just might raise questions with respect to the value of the Founder’s stock.

To further lower the value of the Founder’s stock, the investors can be offered Series A Preferred Stock, say, at a par value and price of perhaps \$1 per share. Generally, the preference relates to a preference upon liquidation of the corporation over the Common Stock, and equal with and pro rata to any subsequent rounds of financing in the form of another series of Preferred Stock. This structure will make it easier to raise further rounds of financing than if the first series of Preferred Stock had preference over all subsequent series.

The practice has evolved of valuing the Common Stock at 10% of the Preferred Stock in a start-up (e.g., \$1 Preferred Stock, \$.10 Common Stock). This measure is used, not so much for the Founder who got in early, but for the Incentive Stock Option (“ISO”) Plan for key employees. Pursuant to the Internal Revenue Code, ISOs are available for employees only.

So now the corporation has three categories of shareholders: Founders, investors and key employees. A fourth is needed: non-employee directors and consultants. These may be granted either in the form of what are known as Non-Statutory Stock Options under an Omnibus Stock Option Plan providing for ISOs and Non-Statutory Stock Options or in the form of simple warrants. A warrant is essentially an option, however, the term “option” is generally used when a Stock Option Plan is involved and a “warrant” when there is no specific Stock Option Plan.

At this point the principal differences between an ISO and a Non-Statutory Stock Option or a warrant should be noted. The exercise price (“strike price”) of an ISO must be at least fair market value on the date of grant; there is no tax on grant or exercise. The only tax is on the gain at the time of the sale of the underlying stock (i.e., a tax at capital gain rates on the difference between exercise price and sales price). However, to qualify for ISO treatment, the stock may not be sold for one year after exercise or two years after grant, whichever is longer. This requirement can be frustrating in the event the stock price is falling. Note that the alternate minimum tax does apply to the exercise of an ISO. A Non-Statutory Stock Option or warrant can set the exercise price at any amount. While there is no tax on grant, there is a tax on exercise and the “spread” (i.e., the

difference between exercise price and fair market value on the exercise date) is taxed at ordinary income tax rates. From the corporation's perspective, there is no income tax deduction attributable to an ISO. The corporation, however, may deduct the "spread" upon the exercise of a Non-Statutory Stock Option.

In both instances there may be a need for careful timing of the sale because one must hold stock acquired through exercise of an ISO for a year after exercise and with respect to stock acquired through exercise of a Non-Statutory Stock Option for a corporation which subsequently goes public, Rule 144 under the Federal Securities Act of 1933 requires holding stock for one year prior to a public sale through a broker.

So now the corporation has all the usual categories of shareholders: Founders, investors, key management and directors/consultants.

IV. PIE-SLICING

Deciding what percentage of the company each category of shareholder will receive (so-called "pie-slicing") is an art, not a science. As has recently been seen, "dot.com" companies obtained valuations that were extraordinary, if not just plain crazy. Suffice it to say that valuation, which directly affects pie-slicing, depends on several factors:

- (a) the fervency (passion) of the Founder;
- (b) the quality of the "mouse trap" (product or service) and its intellectual property or other niche protection;
- (c) the quality of the management team;
- (d) the size of the market for the product or services; and
- (e) the anticipated profit as reasonably reflected in the business plan.

One method that can be used to determine what slice to give the investor is to attempt to reasonably anticipate the value of the company by taking a multiple of gross revenues, EBITDA or net income from the business plan to estimate the company's enterprise valuation and then see what percentage of the company would be required to yield a 200% return to the investor (money back plus 200%). The valuation method implemented by the Founders and the relevant multiplier will depend upon the type of business the company operates and the valuations of comparable businesses. For example, many "dot.com" companies were valued by taking a multiple of gross revenues or a multiple of total subscribers or a multiple of number of pages viewed. Valuation is simply what the market (investors) will bear. If the initial prospective investors are individual Angel investors, the company with its advisors will usually set the valuation. If venture capital firms or investment bankers are involved for later rounds, they will usually set or negotiate the valuation.

For our example, the Founders have established a valuation of \$10 million for the company and have assumed 70% of the equity of the corporation will be held by them,

with another 15% “reserved” for stock options and warrants and 15% for the investors. The \$10 million valuation may ultimately be too rich for venture capital or investment bank investors who will typically apply an aggressive discount rate to any valuation based on the risk and time involved with such investment. After a period of negotiation, the valuation is changed to \$5 million, a more reasonable amount from the investors’ perspective. This means the Founders’ interest will be reduced to 65%, stock options and warrants reserved for issuance will remain constant at 15% and the investors will purchase 20% of the company with an investment in Preferred Stock of \$1,000,000.

Assuming we authorized 10,000,000 shares, we then have:

	<u>Number of Shares</u>	<u>Percentage</u>
Founder(s), Common Stock issued for the exchange of assets or minimal cash	6,500,000	65%
Investors, Series A Preferred Stock issued for \$1 million with a \$.50 par value and liquidation preference	2,000,000	20%
Stock Options/Warrants, Common Stock (reserved for issuance under a Stock Option Plan)	<u>1,500,000</u>	<u>15%</u>
TOTAL	10,000,000	100%

This could be typical if the Founder had a strong protected product and niche. There are any number of variations. It is simply by way of illustration. Often before being able to go out to a venture capital firm at a \$5 million or \$10 million valuation, the Founder would have to further develop the product and business by obtaining smaller amounts of venture financing through friend and family financing or through Angel investors.

V. THE FUND RAISING

Please refer to the other Primers for information covering this subject.

In our example, this seed round would either be (a) a Rule 506 private offering if by the issuer and the issuer had “pre-existing relationships” with many accredited investors or had a placement agent who did, or (b) a Wisconsin Section DFI-SEC 2.028 of the Wisconsin Administrative Code private offering which does not require a pre-existing relationship and allows for 100 non-accredited investors, provided no more than \$1,000,000 worth of the corporation’s securities are offered in a 12-month period.

VI. SUMMARY

The author hopes this small Primer may be of some help to entrepreneurial Founders in planning during the very early stages of their structuring. Frequently we find a Founder with no stock, a desire for much stock, no money of his or her own invested and having already raised some private money. This is comparable to an Emergency Room receiving a person with a severe heart attack. It calls for quick, remedial action.

Let's hope the reader can get some background from this and the other Primers and consult with professional advisors to be able to avoid the legal equivalent of the costly need for the E.R.