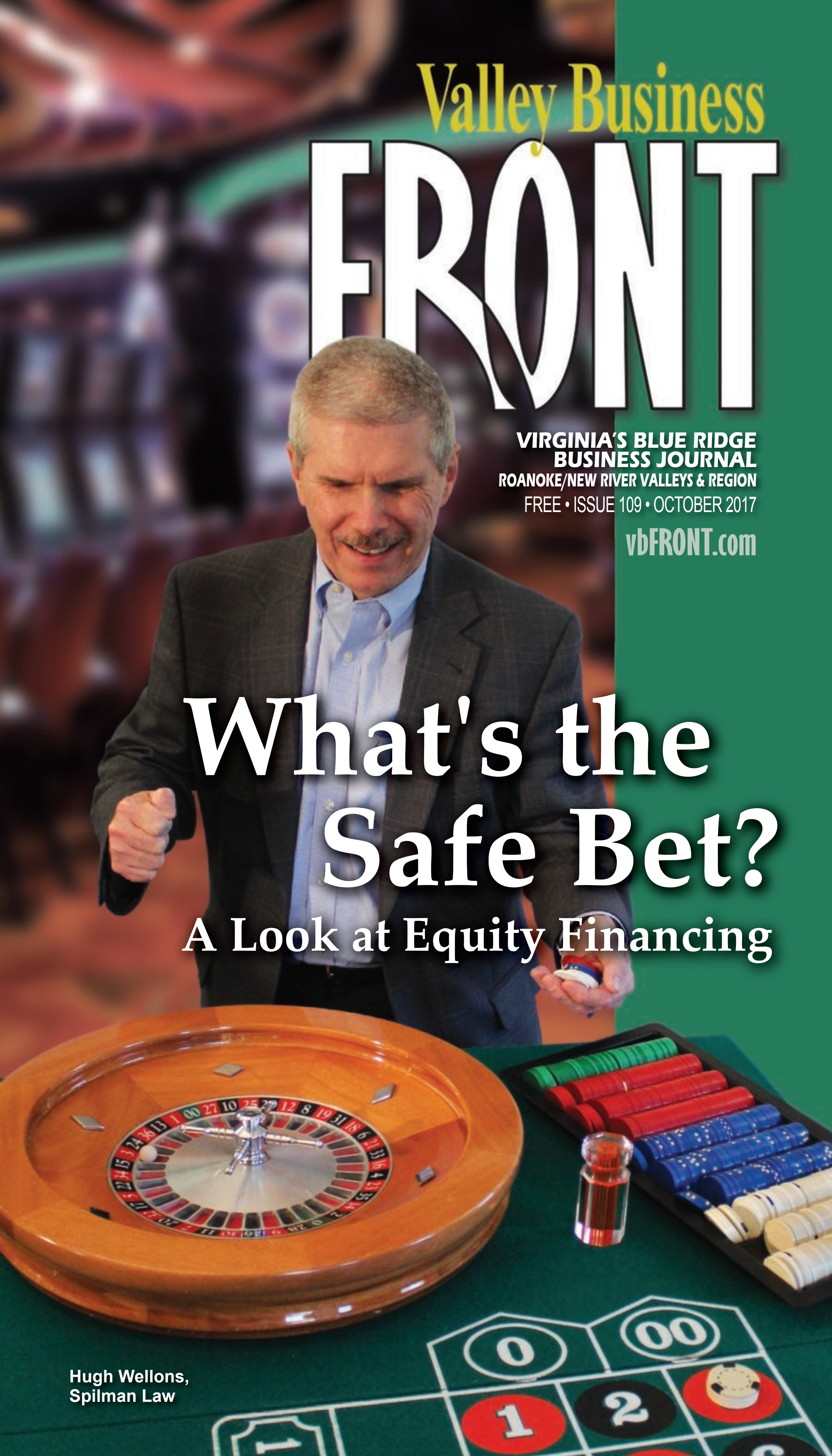

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What's the Safe Bet?

A Look at Equity Financing

Hugh Wellons,
Spilman Law

WELCOME to the FRONT

I'm not ashamed to admit a reality television show sparked the idea for our FRONTcover story this month. *Shark Tank* currently runs on ABC; it's an Emmy® Award-winning series that features a panel of high powered celebrity entrepreneur-investors who listen to pitches from dreamers with ideas to strike it big. I do like to hear the pitches (they're fun to judge as a viewer, before the celebrities respond), but my second favorite part is when the panel members decide they are indeed, interested. Either a little—or a lot (though part of the experience if it were truly real life, is to not appear too excited). It's not the money thrown at the deal that piques my interest the most… it's the offer of equity.

I might not give you $100,000 in seed capital; but I'll give you $25,000 and I "only" want 20% equity.

Many pitchers squirm. Some just say no. But the majority will capitulate or perhaps negotiate a bit before accepting some trade in equity.

Equity is the fascinating part. Sellers and buyers are, quite simply, betting. It's a risk any way you slice it (high or low) and even the most competent high rolling angels and venture capitalists will admit there is no sure thing when it comes to putting stake in a new venture—regardless how promising.

It's rather funny how Shark Tank never shows our pitchers "lawyering up." And though they may have been coached and warned, I see no ear-pieces in their bobbing heads during the presentation where they might be getting feeds from a knowledgeable IP or finance attorney.

I doubt the super-successful celebrity panelists themselves marched into their fortunes with nary a lawyer; but what the heck… it's pretty great television.

Meanwhile, you can see what a few of our own experts have to say about equity protection. Take a spin.

Tom Field

"This time he is being careful not to rely too much on any single large client" — Page 28

Money for Your Business:

Who You Play With & How You Protect Yourself

Equity Financing Options >

Executive Summary: *With all the startups and business expansion and new development announced in our region, somebody somewhere is always going after the money; here's our report on that rather complex process.*

By Nanette Levin

Venturing into the financing arena

Attitudes are mixed about how much money is around in the greater Roanoke area through Venture Capitalists, Angels and other equity financing vehicles. Some cite more deals are being done. Others tick off Angels that have disappeared. Then there are those that question what constitutes a local deal. Is it money coming from the area or into the area – or both?

All seem to agree, though, it's wise to know what you're in for before you leap into exchanging money for business equity. This applies whether you're doing the giving or the taking, which doesn't have as clearly defined lines as you may think when it comes to entrepreneur vs. investor. Those interviewed for this article all also warned about surprises business owners can face once they get into the game.

If you're looking for someone to lend a hand – and their money – in bringing your business to the next level, you'll enjoy the perspectives and humor provided by the four attorneys and two in-the-trenches licensing liaisons featured. If not, you'll probably want to read on anyway, because there's likely something they shared that will make you sound smart the next time you talk about money to your colleagues and friends. Well, actually, as one attorney puts it, the borrowing side usually includes "friends, family and fools," so maybe you'll be smarter being quiet.

What attracts VCs?

"Always bet on the jockey, not the horse – that old adage often applies to this (the equity investment realm)," says Hugh Wellons of Spilman Law. "That's why a lot of professional money – Angels and/or Venture Capitalists (VCs) – are attracted to people who have been down the road before." Such entrepreneurs know where to focus hard work first. Winning jockeys are quick to figure out horses and tend to get the better mounts. Successful serial entrepreneurs offer attractive enticements for those seeking likely business winners to bet on.

"That doesn't mean you can't get money if you're starting out," Wellons says, "but if you've done it before, it helps. It shows you have some degree of business acumen."

Keith Finch, of the Creekmore Law Firm, notes that the majority of VC deals go to tech firms. He indicates their profit formula is to invest in a relatively large number of high tech companies that can show dramatic growth without the need for a lot of cash flow to do so. This means mostly virtual companies. A business that needs to buy, inventory and ship product ties up too much money for too long to be attractive to most VCs.

"They are not looking for a company that's going to be very profitable," says Wellons. "They're looking for a company that potentially is going to be a grand slam homerun – not one to two times their money but 10-100 times returns." He explains that eight of ten companies VCs invest in will fail, one will make some money, and one will pay for all the others.

"If you're the one that's the big hit, you feel like you gave them too good a deal," says Wellons. "It's like if you send ten idiot brothers to Las Vegas and nine of them lose all

> A start up should not take more money than it needs
>
> *— Keith Finch*

Keith Finch

“”

If there are concerns that make the risk too high, debt financing may be a better option; debt gets paid before equity

— Hugh Wellons

Hugh Wellons

their money and one makes five times what they took. That's just the odds. Of course, the house won. The one who made all the money thinks he's smarter than the others. They're (venture capitalists) looking at you as one of a bunch of investments they're making," he explains.

"This area is changing significantly with the influx of companies and researchers involved with Virginia Tech and the research institute. That's going to change the dynamic here again," says David Tenzer of Glenn Feldmann. "When you talk to people, a lot of it really depends on the industries they've been working with, the companies they've been working with. In this Roanoke market, there are not hundreds of venture capital firms working here doing thousands of deals. Deals are very company specific in this market," he states.

> Deals are very company specific in this market
>
> *— David Tenzer*

Other options for financing

Angels come in earlier but also make less money and tend to have lower expectations than VCs, according to Wellons. They want to invest in what they know and check in often if they're sophisticated, he says. They may have a seat on the board. "If you pick the right ones they're also great mentors. They want to help. They want to make money with you, want to spend the time to coach you to be a success," Wellons states.

Whether you're talking to an Angel or a VC, Wellons suggests seeking some critical synergy that includes getting along with the people offering the money and finding a partner that has the skills you lack to help shore up weaknesses.

"The structure of the deals varies significantly from deal to deal," Tenzer explains. "A lot of it depends on who the investors are, who the current owners are, what their needs are and what kind of structure will work best for all."

Convertible debt is often part of a financing agreement, according to Tenzer. He explains that equity investors share all the profits and losses. Even with preferred stock, this is a risky proposition as the investor only gets paid when the stock gets sold.

But, if there are concerns that make the risk too high, debt financing may be a better option. Debt gets paid before equity. Convertible debt allows for a transition to equity financing after certain events occur or benchmarks set are met. "There's a huge advantage if things go wrong to be invested in debt rather than equity of a company," Tenzer says.

"In times where the economy is down in a particular sector and there is heightened risk associated with that sector, you see more convertible debt than equity," Tenzer explains. He notes that more straight equity deals occur during optimistic times.

David Tenzer

Mark Coburn

Michael Miller

Clients don't value money as much as the people who have it do
— *Hugh Wellons*

Mark Coburn, President of Virginial Tech Intellectual Properties, Inc. (VTIP) and Micheal Miller, Senior Licensing Manager, use some creative approaches for commercializing an idea. They work with 300-400 inventors annually to bring research discoveries to the marketplace.

"The strength of our office is everyone acts in a flexible manner," Coburn says. While licensing agreements are inexpensive (although the entrepreneur does pay for the patent process), they put strong pull back clauses in these agreements and are quick to rescind rights if diligence terms aren't met.

"The goal isn't to make money, it's to make a difference" says Miller. Some of the ways they do that is through collaborations with firms such as Middleman Capital Fund, which can provide funds in lower denominations than traditional equity financing firms. They also have forged relationships with a variety of organizations such as the Center for Innovative Technology, which matches funds received for SBIR grants. A big focus is on education, so an entrepreneurs network offers mentors, including successful business owners, willing to guide faculty through the process of bringing an idea to the marketplace and the associated business formation and organization issues that may arise.

Virginia Tech discoveries are now being commercialized in areas including San Francisco, Montreal, Pennsylvania and Kentucky. This is due in part to VTIP staff proactively seeking good matches in companies or individuals for the inventions that have been logged.

What's valuable in your company?

According to Fourd Kemper, chair of the Emerging Growth practice group at Woods Rogers, there are four major categories of intellectual property (IP), including trade secrets or knowhow, patents, trademarks and copyrights. He cautions business owners to ensure they have favorable rights agreements with employees long before the seek outside capital as well as confidentiality agreements in place with potential funders once they do.

Kemper explains the different types of IP in layman's terms. The Coca Cola formula is a trade secret. Patents offer a monopoly for an idea. Trademarks protect what you use to market your business. Think Owens Corning's insulation and the Pink Panther. Copyrights protect the expression of an idea. "So, if you write a song or write a newspaper or write a book or paint a painting, that expression gives you the copyright as the creator," Kemper says. "You'll have rights even if you don't file anything (with the federal copyright office)" he explains.

"A problem I have had with clients is that clients don't value money as much as the people who have it do," says Wellons. "A client will develop IP and in his or her mind, that's the most important part of this project. They're right. You can't have a new widget without having a design for the widget. But equally important in its own way is having the right amount of money to move forward and the right amount of good advice to move forward. People who have money and do this for a living understand that, great, you have a world class idea, I can make a lot of money on that," Wellons states.

He notes, however, profit is dependent on whether it works, lacks competition, is developed with discipline and funds are available for regulatory and marketing challenges. "Having a water engine is great if you can get it funded. If you can't get it funded it's just another piece of scrap metal," Wellons says. "That's a hard message for someone to take – it may be their life's work – 10 to 20 years developing then someone wants to write you a check and say I own half or more," he explains.

Is more money better?

Big deals grab attention when it comes to venture capital, but according to Finch, these aren't always cause for celebration. "A start up should not take more money than it needs. Headlines announcing financing big dollar figures doesn't necessarily mean the founder's got a great deal. They may have sold more of the company than they need to at a lower valuation," Finch says.

"Not all money is created equal," Tenzer adds. He suggests those seeking equity financing look as much at how well the interests and talents of a particular partner mesh with the culture and objectives of the company as the amount of money they may have available. "(Those) having particular interest and expertise in that industry can be very beneficial to the company that's taking on an investment well beyond the benefit that the financial investment might make."

> Always bet on the jockey, not the horse
> *— Hugh Wellons*

Fourd Kemper

> Grants of stock options are taxed just like salary with social security, Medicare and income tax deducted from the compensation
> *— Fourd Kemper*

Angel or Venture Capitalist: What's the Difference?

ANGEL INVESTMENT

Put simply, an angel investor is someone who puts their own finance into the growth of a small business at an early stage, also potentially contributing their advice and business experience. They might be a wealthy, well-connected individual who's taken a personal liking to your product, a group of angel investors who club together to fund startups, or even a friend or member of your family who's decided to put some money in.

Angels make their own decision about the investment, and in return for providing personal equity they take shares in the business. The amount they invest is flexible – it could be a small amount to get you off the ground, or a larger amount. While they can provide insight and advice about your business, their job isn't to build up your company.

VENTURE CAPITAL

Venture capital funding is a whole other level. For a start, rather than individual investors, winning venture capital usually involves a whole firm – investors, board members, and people whose job is to generally help your business develop. Venture capital firms are made of professional investors, and their money comes from a variety of sources – corporations and individuals, private and public pension funds, foundations.

Those who invest money in venture capital funds are called 'limited partners'; those managing the fund and working with individual companies are called 'general partners', and these are the people who work with the startup to ensure that its developing.

The job of venture capital firms is to find businesses with high growth potential. The firm take shares and have a say in the future of the company and its running, and in exchange for their involvement venture capitalist firms expect a high return on investment. After a period of time, often years, the venture capitalists sell shares in the company back to the owners or through an initial public offering, hopefully making much more that what they put in.

Venture capital usually deals with very large amounts of money – rather than seed funding, it can be multi-million deals. And while more and more startups are winning venture capitalism investment, with the sums involved and the risk of investing in a startup, businesses a bit further down the line might be more likely to gain the trust and money of venture capitalists.

SOURCE: *VirginStartUp.org*

Beware of Securities Law

"When you go from using your own funds to using someone else's funds, there are a lot of responsibilities you have to whoever's money you're using," cautions Wellons. "The fiduciary responsibility switches. It's almost the business equivalent to having children. You just can't be acting in your own interests. For some entrepreneurs, that's a tough switch to make," says Wellons.

He points out that when it comes to things like your salary, leasing property you own to the business, or intellectual property you are, in effect, leasing to the business – all of a sudden you can't make those deals without taking into account the other people who have invested in you.

"Venture Capitalists understand that very well," Wellons states. "So do sophisticated angels," he adds. They create deals that allow them to step in and influence management. "That is a surprise to a lot of people," Wellons notes.

Finch explains there was a time when companies would pay employees or vendors with stock options without giving it much thought. Today there are many pitfalls with this kind of thinking, particularly as it relates to securities law and taxation.

The laws have changed in recent years relative to what is permissible when it comes to borrowing or lending money for a business venture. According to Finch, this was the result of the high-tech valuations skyrocketing and the IRS wanting their share. Employees who were paid with stock weren't taxed on that in the past. Some who became wealthy as the result of IPOs didn't pay income tax as the federal government felt they should.

Now grants of stock options are taxed just like salary with social security, Medicare and income tax deducted from the compensation, Finch notes. That means those choosing to pay in this way must have a clear understanding of what their company is worth. The IRS can change that number, so wise owners make this assessment through the services of an independent valuation expert, he says. Plan on spending thousands for this service.

Finch explains that the revised tax laws require careful thought as owners try to reinvest in their business. Capital expenses depreciate, so owners putting money back into the business now need to factor in withholding. He illustrates a $100k income business where all the money coming in was spent on machinery. But capital expenses depreciate, so the company still has $60K in income for reporting purposes, but no money to pay for the associated taxes.

Vendors being paid in stock options used to face the same issue. This is known as phantom income. Finch underscores the importance of "realizing how incredibly complicated it

"Not all money is created equal"
— David Tenzer

is to give shares to people." When stock in lieu of payment recipients complained, the laws were changed to require withholding on these payments too.

Wellons notes that if you're borrowing money from an accredited investor (someone with a net worth of at least $1 million excluding the primary residence and annual income of at least $200K single, $300K married) your responsibilities lighten as there's more expectation on the lender to take care of themselves.

Protecting your rights

All attorneys interviewed stated the importance of getting the right people in place early on if you may be looking for financing in the future. Everything, from the type of business structure you set up and the manner you use to secure IP to how you handle employee and vendor relations, can affect the value of your firm to equity partners. All cite seasoned IP attorneys and accountants familiar with the intricacies of equity financing as critical early hires.

"As companies grow, sometimes financing becomes an issue in terms of fueling growth," Tenzer notes. He explains that the traditional way to handle this is to bring in a partner or sell stock. When it comes to Venture Capital arrangements, securities law increases the complications of such exchanges. Tenzer advises those considering this type of arrangement engage an attorney who specializes in equity financing early to ensure company formation and other issues are handled right long before the search for capital begins.

Kemper underscores the importance of protecting IP rights. He cites protecting software code, securing favorable licensing agreements, owning patents and paying attention to all the details of the business from the beginning. He indicates that if what investors initially look at shows careful attention and is clean, they're more likely to go through the rest more leniently.

Wellons says it's important to be very clear about time lines and other expectations before entering into an equity financing agreement. "The business owner needs to be honest about where he or she fits," he explains. "The earlier they start the process of getting ready for that, showing growth, reducing expenses or expanding IP, cleaning up corporate documents, etc., the more likely that they will be successful in attracting investment," he notes.

Finch cautions that all 50 states have individual securities laws in addition to federal mandates that require disclosures. Getting this wrong can have you paying back money loaned, or worse.

Where can startups find resource partners?

Kemper cites resources such as seminars offered by RBTC (the Roanoke-Blacksburg Technology Council), RAMP (the new Roanoke accelerator), and the Small Business Development Center as ways for company owners to get better educated about what constitutes IP while offering a place to find knowledgeable people to join their team. He also suggests Roanoke College, Virginia Tech, Hollins, Liberty University and other area higher learning institutions as good resources. "The best thing to do is, if you meet a lawyer early on that you like and that will grow with you and is conversant in these issues and has the expertise to guide you right from the start (hire him)," Kemper says.

Many attorneys will provide an initial consult without charging for their time.

At VTIP, they've built a network of resources and contacts to introduce both inventors and the entrepreneurs who license their discoveries to the people who can help bring research through company formation or expansion to the marketplace.

Perhaps the house always wins at the end of the day in gambling, even if some win at the losers' expense. Smart business deals, however, are designed to encourage solutions where everyone wins. If your sights are set on bringing in someone else's money to help you reach your dreams, those familiar with the issues of equity financing feel it's wise to hedge your bets by talking to people who have forged this path before you. They say the right kind of expertise can help reduce surprises as you work through your strategies for success.

"A lot of your clients are trying to save the world, so you get to meet a lot of interesting people," concludes Wellons. He says he loves his job.

> "The best thing to do is… meet a lawyer early on that you like… will grow with you… is conversant in these issues… and has the expertise to guide you right from the start"
>
> *— Fourd Kemper*