



The Texas Entrepreneur &
Angel Investor Conference
**Issues on Structuring
the Angel Investor Deal**

Matthew Lyons
Andrews Kurth LLP
111 Congress Avenue, Suite 1700
Austin, Texas 78701
(512) 320-9284

mlyons@andrewskurth.com

www.andrewskurth.com

Overview

- Key Terms
- Basic Deal Structures
- Angel Investor Issues
- Common Pitfalls
- Questions & Answers

Key Terms

Key Terms

- **Pre-Money Valuation** – the value of the business before any investment by an outside party
 - Possible to avoid / defer through the use of convertible bridge loans
- **Post-Money Valuation** – the value of the business after the completion of an investment by an outside party
- **Common Stock** – the most basic form of stock representing the residual value of the company; held by founders and employees
- **Founder's Stock** – these are the shares that the founders of company purchase or typically receive at the creation of the company, usually for very low value (e.g. \$0.001 per share)
- **"Reverse" Vesting** – a mechanism to provide for time-based vesting, *often imposed by an investor after the fact*, to permit a company to repurchase a decreasing percentage of shares of founder's stock over time based on a vesting schedule

Key Terms

- **Option Pool** – a portion of the company's outstanding stock set aside for use as incentive compensation for present and future employees. Allocated and unallocated amounts and required increases included in pre-money valuation
- **Preferred Stock** – a form of stock usually held by investors with certain rights and preferences superior to those of common stock, including liquidation preference, redemption and anti-dilution rights, and governance, voting and board rights and restrictions
- **Liquidation Preference** – the right of preferred stock holders to receive the value of their investment before any other liquidation distributions are made to other equity holders. Usually includes "participation" provision for the preferred stock to continue to share proceeds with the common
- **Antidilution Rights** – the right of preferred stock holders to maintain its fractional ownership percentage if shares are later issued at a lower valuation

Preferred Stock Liquidation Scenarios

Example One: Participating Preferred – \$10 million sale price

Preferred Stockholders invested \$5 million for 50% of the company.

	<u>Preferred Stock</u>	<u>Common Stock</u>
Preference	\$5,000,000	\$ –
Participation	<u>\$2,500,000</u>	<u>\$2,500,000</u>
Total	<u>\$7,500,000</u>	<u>\$2,500,000</u>

Preferred Stock Liquidation Scenarios

Example Two: Participating Preferred with 3x cap – \$25 million sale price

Preferred Stockholders invested \$5 million for 50% of the company.

	<u>Preferred Stock</u>	<u>Common Stock</u>
Preference	\$5,000,000	\$ –
Participation	<u>\$10,000,000</u>	<u>\$10,000,000</u>
Total	<u>\$15,000,000</u> *	<u>\$10,000,000</u>

* Note that the cap was reached but Preferred will not convert, as there is no difference

Preferred Stock Liquidation Scenarios

Example Three: Participating Preferred with 3x cap vs. fully participating preferred – \$50 million sale price

Preferred Stockholders invested \$5 million for 50% of the company.

	<i>3x Capped Preferred</i>		<i>Fully Participating Preferred</i>	
	Preferred Stock	Common Stock	Preferred Stock	Common Stock
Preference	N/A*	\$ –	\$5.0 million	\$ –
Participation	<u>\$25,000,000</u>	<u>\$25,000,000</u>	<u>\$22,500,000</u>	<u>\$22,500,000</u>
Total	<u>\$25,000,000</u>	<u>\$25,000,000</u>	<u>\$27,500,000</u>	<u>\$22,500,000</u>

* Note: 3x Cap (\$15 million) would result in lower proceeds, so Preferred converts to Common

Basic Deal Structures

Structures

- **Straight Loan** – very simple and no valuation needed, but no upside to investor; rarely used
- **Bridge Loan**
 - Type 1: Convertible at next round price & no warrant coverage. Less “upside” compared to the risk of angel investment
 - Favored by companies and VCs
 - Type 2: Convertible at next round price with X% warrant coverage.
 - Requires closing at least \$250,000 to avoid Texas state usury laws
 - Type 1 and 2 most common
 - Type 3: Convertible at discount to next round price **but** generally prohibited in Texas due to “usury” concerns
- **Common Stock** – simplest structure with minimal transaction costs but requires an implied valuation; rarely used
 - “taints” option price
 - Offers no investor protection
- **Preferred Stock**
 - “Seed” Preferred: simple liquidation preference and other terms to permit some “discounting” of options
 - Standard Preferred: standard “venture capital” formula preferred stock favored by more experienced investors but entails higher transaction costs
 - Use varies with size of investment



Angel Investor Issues

Angel Investor Issues

- “Lock in” value of the investment or discount commensurate with risk (e.g. lower price than VC round)
- Participation on the Board of Directors and in business oversight
- Maintaining rights & preferences in future VC rounds of financing
- State usury laws prohibit $> 18\%$ interest
 - Interest includes all other benefits payable (e.g. next round discount); warrants included on $< \$250,000$
 - Under Texas law, the penalty equals the greater of (1) 3x the difference between the amount charged and the amount legally permitted amount or (2) the lesser of \$2,000 or 20% of the principal



Common Start-up Pitfalls

Common Start-up Pitfalls

- Inadequate early stage structuring and poor recordkeeping (especially equity)
- Failure to protect intellectual property assets
- Investment by too many (or the wrong) friends, family and angel investors (administrative and management burden)
- Previous violations of state securities laws
- Unrealistic expectations of inexperienced early investors
- Previous unsupportable valuations
- Unique or non-standard terms in earlier financing agreements requiring significant revisions
- Too many board members and advisors (“hangers on”)
- Brokers and finders



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Questions?

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ANDREWS
ATTORNEYS **KURTH** LLP