

PREPARING THE COMPANY

Almost every entrepreneur or business owner who has raised capital for his or her company has found that raising capital was far more difficult, expensive and time-consuming than anticipated. For many entrepreneurs and business owners, raising capital becomes a full-time job in addition to the full-time requirements of running the business.

Entrepreneurs and business owners should assume that every aspect of the business will be scrutinized carefully each time that capital is raised. This scrutiny may come from investors themselves (particularly venture capitalists), from placement agents who assist in the private placement of securities, from underwriters of registered offerings, and from the company's own advisors such as attorneys and auditors. Although often perceived by companies as an obstacle to raising capital, this scrutiny or due diligence can give the company and its directors and executive officers great protection against claims of fraud or misrepresentation.

PREPARING A BUSINESS PLAN

Entrepreneurs seeking to raise capital should develop a written business plan that demonstrates to lenders and investors that the entrepreneurial team has thought through the key drivers of the venture's success or failure. A business plan is a distinct document that is separate from other documents which will need to be prepared to raise capital—such as a private placement memorandum or

a prospectus (both of which are discussed in later sections of this publication). Numerous books and articles have been published on the topic of business plans with differing opinions as to the proper form and content. At a minimum, a business plan should describe:

- the business opportunity, including a market analysis reflecting a deep knowledge of the industry and the distinguishing characteristics of the primary target market segments;
- the company, its core competencies, competitive advantages and stage of development;
- the company's products or services, key aspects of its intellectual property, its research and development activities and, if applicable, its regulatory history and anticipated pathways;
- the company's sales and marketing strategies, distribution channels, promotional activities and sales force;
- the ownership of the company;
- the people who will be managing the business and any other key employees or consultants, with highlights about their backgrounds and business experience;
- the factors that may influence the success or failure of the business; and
- relevant financial data and analysis which may include a description of anticipated research and development or regulatory milestones and the amount of capital necessary to reach each of those milestones.

A written business plan is usually necessary for a company to obtain debt or equity financing, and it can also serve as a guide for a company's development. Writing a business plan helps the entrepreneur identify the strengths and weakness of a new business venture and develop a strategy for the company's future growth. The business plan can also provide a framework for turning ideas into actual business practices, products and services.

Business plans tend to be overly optimistic and often contain highly unrealistic financial projections. While sophisticated investors, such as venture capital firms, are cognizant of this tendency and usually discount exaggerated statements, the entrepreneur should always present an accurate and realistic business plan. If a business plan is distributed to prospective investors in a capital raising effort, as is often the case, the entrepreneur could be subject to liability under the securities laws for any fraudulent statement. The entrepreneur is well-advised to have his or her business plan reviewed by a competent securities lawyer before giving it to prospective investors.

EQUITY STRUCTURE CONSIDERATIONS

Raising equity capital involves selling additional shares of a company's stock to new investors, who will become shareholders in the company. Before selling equity securities and increasing the number of shareholders, the company's founders should consult with legal counsel to determine whether there are any corporate actions requiring shareholder approval that the company should take while there are still a small number shareholders and shareholder approval is relatively easy to obtain. State corporation statutes, for example, generally require shareholder approval to amend a company's articles of incorporation, change its capital structure or undertake certain other corporate restructurings. In addition, the federal tax laws require shareholder approval of certain stock option plans in order for certain types of options to be eligible for favorable tax treatment.

The company's equity structure (i.e., the way ownership in the company is divided up and represented) should be designed to achieve maximum flexibility in structuring future equity investments. The form of business entity and its jurisdiction of organization should also be reviewed before undertaking a significant capital raising transaction. The company may have been formed as a C corporation, an S corporation, some form of partnership, a limited liability company, or some other entity. The advantages and disadvantages of each type of entity vary based upon, among other things, the business plan and jurisdiction of organization. In addition, an entity's organizational documents could limit the particular type or amount of securities that it may issue, or the issuance of a particular type or amount of securities could have adverse tax consequences or other implications for the company or its owners.

PREPARING FOR THE DUE DILIGENCE PROCESS

Entrepreneurs who expect someday to seek capital financing should be mindful during the early stage of their business of the legal and business "due diligence" process associated with raising capital. "Due diligence" refers to the detailed examination of a business which is performed by sophisticated investors, such as venture capitalists and investment bankers before they will make an investment or attempt to raise capital for a company. Even if financing may not be sought for several years, it is generally easier and cheaper to deal with issues appropriately at the company's development stage rather than later when the financing is imminent. In these early stages, the entrepreneur, with the assistance of competent counsel and financial advisors, should pay careful attention to details in the following areas:

- Maintaining accurate and complete corporate records, such as charter documents, bylaws, and minutes of meetings of the board of directors and shareholders;

- Maintaining appropriate financial records;
- Protecting intellectual property (trade secrets, patents, trademarks);
- Compliance with laws in a variety of areas, including corporate and business licensing, securities, employment, workers' compensation, ERISA, tax (federal, state, local, sales and use, and withholding), environmental, zoning, restrictions on investment in the U.S. by foreign persons, and import/export;
- Avoiding burdensome contractual commitments that may reduce flexibility or be difficult to meet or terminate;
- Developing appropriate forms of standard contracts, purchase orders and invoices; and
- Capitalization (the manner of structuring the company's debt and equity)—the capital structure should permit maximum flexibility for various methods of raising capital.

LEGAL DUE DILIGENCE VS. BUSINESS DUE DILIGENCE

Business owners should anticipate both business and legal due diligence to be conducted in connection with the financing. Business due diligence will involve a careful analysis of the company's business plan, financial statements, products, technology, markets, competition and management team. Counsel for the investors will conduct the legal due diligence.

PRINCIPAL CONCERNS OF LEGAL DUE DILIGENCE

Legal due diligence will usually focus on several principal areas of concern:

- **Ownership and Protection of Technology.** The principal assets of many start-up companies are technology and the founders' ability to develop and market the technology. Therefore, prime concerns will be establishing the ownership of technology, ensuring that it does not infringe other technology and verifying that it is not being infringed by others. If a patent is vital to the company's business, the company should have competent patent counsel available to advise it and, if required, to deliver a legal opinion.

If the entrepreneur developed the technology while employed by another company, he or she should be prepared to establish that the technology was developed on his or her own time without the facilities or resources of the employer and that there has been no misappropriation of trade secrets of the former employer. In addition, the ability of the entrepreneur to develop and market the technology may be restricted if the entrepreneur has executed any non-competition or confidentiality agreements with former employers. Any necessary transfer of ownership of technology from the entrepreneur to the corporation should be properly documented.

- **Employees.** Closely related to concerns about protection and development of technology are concerns relating to arrangements with employees in sensitive areas.

Employees, particularly those involved in research and development or marketing, should have executed agreements regarding confidentiality, ownership of inventions and, if possible, non-competition. Minnesota does not have a statute directly dealing with non-competition agreements. Generally, such agreements in the employment context will be enforced

by the courts if they are reasonable in scope (i.e. coverage) and duration, and are supported by adequate consideration.

Employees should be carefully screened to ensure that they have not misappropriated technology or trade secrets or violated non-competition agreements with former employers. A company can also become liable to a former employer if it hires an employee to entice customers from the former employer.

Equity incentives for employees should be carefully structured to vest over time to avoid problems with employees leaving after a short period of time with a significant equity position.

- **Issuances of Securities.** Compliance with securities laws in prior stock issuances is of great importance because violations may result in rescission rights for the early investors and future investors generally will not be willing to allow their investments to be used to rescind prior sales. Investors may also be concerned that their investment not be used to repay early capital contributions made in the form of loans.
- **Contractual Commitments.** Counsel will generally review all of the material contracts of the company for various purposes, including:
 - the verification of contractual rights claimed by the company (e.g., ownership of technology or exclusive rights, employment terms for key employees, sources of scarce materials, leases of facilities and equipment, and insurance);
 - avoidance of potentially burdensome contractual commitments of the company that are not easily terminable; and

- ensuring that contractual arrangements between the company and principal shareholders and other insiders and affiliates are fair and reasonable.

CONFIDENTIALITY AGREEMENTS BETWEEN THE COMPANY AND THE POTENTIAL INVESTORS AND THEIR REPRESENTATIVES

To lessen the likelihood of undesired disclosure of sensitive technology and trade secret information, it may be wise for companies to request that potential investors and their representatives execute confidentiality agreements before disclosing confidential and/or proprietary information to them. Whether such agreements are appropriate will depend on the level of sensitivity of the information to be disclosed.

THE ENTREPRENEURS' DUE DILIGENCE

Entrepreneurs should also be careful to conduct their own due diligence review of potential investors. Investors vary widely in areas of expertise, types of desired investments and contact with other potential investors. In particular, potential venture capital investors should be thoroughly evaluated to ensure that they have a sound reputation and that they will bring not only their initial investment of money, but also necessary managerial skills and sufficient resources and contacts to help support future financing rounds. Venture capital investors should be chosen carefully.

The company may need to verify the status of investors as "accredited investors" for federal and state securities laws purposes to take advantage of exemptions from registration. Section Five, entitled "Private Equity Offerings," contains a more detailed discussion of accredited investors.