



ANGEL INVESTMENT GROUPS, NETWORKS, AND FUNDS:  
A Guidebook to Developing the Right  
Angel Organization for Your Community

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## TABLE OF CONTENTS

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INTRODUCTION .....	1
BACKGROUND .....	2
FUNDAMENTALS .....	6
BUILDING THE FRAMEWORK (CREATING YOUR ANGEL GROUP) .....	10
Community Assessment .....	11
Selecting a Structure .....	16
Decision Steps .....	17
Member-Managed versus Manager-Managed .....	17
Legal Structure .....	20
Investment Structure .....	29
Determination of Membership .....	30
Financial Resources: Funding Your Angel Organization .....	35
Summary of Building the Framework .....	38
GROUP OPERATIONS (IMPLEMENTING YOUR ANGEL GROUP) .....	40
Membership .....	40
Meeting Structure .....	45
Group Budget .....	46
Sponsorships .....	48
Investment Evaluation and Process .....	50
Summary of Group Operations .....	57

## APPENDICES

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Sample Membership Information. . . . .	1
Sample Membership Agreement . . . . .	2
Sample Membership Survey. . . . .	3
Angel Investor Education Program Agenda . . . . .	4
Group Finances: Revenues and Expenses Worksheet . . . . .	5
Sample Funding Application . . . . .	6
Sample Screening Committee Worksheet . . . . .	7
Due Diligence Questions . . . . .	8
Due Diligence Checklist Table . . . . .	9
Glossary of Terms . . . . .	10
Investor Vs. Company Favorable Term Sheet Sample . . . . .	11
Explanatory Term Sheet Sample. . . . .	12
Sample Public Survey. . . . .	13

## TABLES, GRAPHS, AND FIGURES

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Table 1 – Equity Capital Sources for Entrepreneurs . . . . .	4
Graph 1 – National Venture Capital Investments, 2000-2003 . . . . .	4
Table 2 – Venture Capital Funds, 1995-2003 . . . . .	5
Table 3 – VC Seed and Start-Up Financings, 1999-2003 . . . . .	5
Table 4 – Angel Investor Reasoning . . . . .	7
Table 5 – Community Assessment Questions and Process . . . . .	12
Figure 1 – Decision Matrix for Creating an Angel Group . . . . .	16
Table 6 – Structural Pros and Cons . . . . .	17
Table 7 – Member-Led versus Manager-Led Groups. . . . .	18
Table 8 – Legal Structure Comparison . . . . .	28
Table 9 – Creating Your Angel Group Summary. . . . .	38
Table 10 – Organizational Activities and Duties . . . . .	43
Table 11 – Group Expenses . . . . .	46
Table 12 – AHI Tactics for Promoting Sustainability . . . . .	57

# INTRODUCTION

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From 1996 to 2003, the number of angel organizations<sup>1</sup> in the United States increased significantly from an estimated 10 to about 200 groups. This growth occurred because individual angel investors found many advantages to working together — better investment decisions, enhanced deal flow, the ability to combine their funds into larger equity investments, and group social attributes. Nearly all of these groups created their structure *de novo* having little or no guidance or best practices to follow. To meet the need for information, this Guidebook has been developed to help in the establishment of angel groups most appropriate for prospective member investors and related community. It is designed to provide practical suggestions, tools, and best practices in starting and operating an angel group.

Starting any type of group can be a daunting task. Establishing a successful angel group can be particularly difficult because angel groups are a recent phenomenon, and angel investors are notoriously private. To make matters more confusing, many different organizational models or structures have been successful. In addition, success is not necessarily measured by return on investment, since angels typically invest at an early stage, and returns may not be seen for several years. Instead, success may be measured by factors such as member retention, investment rate, accomplishment of goals, and member satisfaction.

Despite a seeming morass of variables and choices, there are basic factors, decision points, and questions that should help you determine the type of structure that best suits you, your member base, and community. This Guidebook is intended to take you through a decision-making process to determine the best structure for you, provide examples of organizational structures and functions, and give you a head start in establishing your angel group with some critical documents and guidelines.

One size does not fit all, however. So, after you have gone through the discussions, questions, and options outlined in this Guidebook and come to a conclusion for a particular step or factor, you may decide to choose a different model just because your membership has a greater comfort level with more or less structure at this point in your organizational development. Recognition and acceptance of the need for growth are important, and willingness to adjust your model, goals, and orientation will be important for your organization's long-term success.

You should be sure to consult qualified counsel regarding federal, state, and local rules and regulations that may govern your organization. Attorneys and accountants can be invaluable to any organization, and you should avail yourself of their knowledge and background to ensure the legality and economic value of your angel group.<sup>2</sup>

<sup>1</sup> Throughout this Guidebook, the terms “group” and “organization” are used interchangeably.

<sup>2</sup> This Guidebook is intended to enhance the reader's awareness of the variables and attributes of establishing and operating an angel organization and should not in any way be substituted for professional advice. One should retain appropriate regional counsel to ensure compliance with local, state, and federal laws.

## BACKGROUND

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Angel investors have proven themselves to be an integral part of the capital market, particularly for funding start-up companies and providing first-phase financing of businesses. The term “angel” originated in the early 1900s and referred to investors who made risky investments to support Broadway theatrical productions. Today, the term “angel” refers to high-net worth individuals, or “accredited investors,” who typically invest in and support start-up companies in their early stages of growth.

**DEFINITION:** *The term “accredited investor” under the Securities Act of 1933, as amended, includes the following definitions with regard to individual investors: “Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000”; and “Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” With regard to organizations, an accredited investor is: “Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000.”*

In the financial world today, angel investors are a critical and essential part of a healthy economy, particularly for the establishment and growth of early-stage companies. Experts estimate that, on a cumulative basis, the level of investments made by angels over the last 30 years has been double that of investments made by venture capitalists.<sup>3</sup> The Center for Venture Research (the “CVR”) at the Whittmore School of Business and Economics at the University of New Hampshire<sup>4</sup> estimates that angel investments for 2003 were approximately \$18.1 billion in 42,000 deals, down from the historical — last 10 years — investment trend of approximately \$30 billion per year in 50,000 ventures. This investment amount is comparable to venture capital funds, which, according to the National Venture Capital Association, invested \$18.2 billion in 2003, with only 2% of those dollars in seed or early-stage investments.

In addition to the value provided by early funding, angel investors are typically experienced professionals who can offer wisdom and guidance to the entrepreneur and who have the patience to allow time for normal company maturation. With few exceptions, angels invest on a regional basis, being interested in personal relationships with companies and employees, as well as in giving back to their communities.

<sup>3</sup> According to statistics published by the National Venture Capital Association and the Center for Venture Research, University of New Hampshire.

<sup>4</sup> Sincerest thanks and appreciation to Dr. Jeffrey Sohl, Director of the Center for Venture Research, for permission to use selected results of the 2003 angel group survey.

Angel groups, which have more resources than individual angels, are playing a more crucial role in funding young companies, as well as in funding second-stage companies, leveraged buyouts, and spin-offs. Historically, the funding gap between investments made by friends and family and the point at which companies could realistically obtain financing from venture capitalists was between \$500,000 and \$2 million in invested capital. Individual angels could often meet these funding needs. However, with venture capitalists moving further up the

funding chain by not investing as early in a company's development, a second funding gap has emerged between \$2 million and \$5 million.<sup>5</sup> Added to this problem of venture capitalists preferring larger deals is the definitive drop in venture capitalists funding seed or start-up stage companies. The following table and graphs demonstrate this trend in the last few years of significant decrease in venture capital funds both of numbers of investments and of total dollars invested.

**DEFINITIONS:** *The definition of these various stages of business development and corresponding financing can vary between publications and individuals. For purposes of this Guidebook, the following definitions for stages of financing will be utilized from Pratt's Guidebook to Venture Capital Sources; 2001 Edition, Thomson Financial/Venture Economics:*

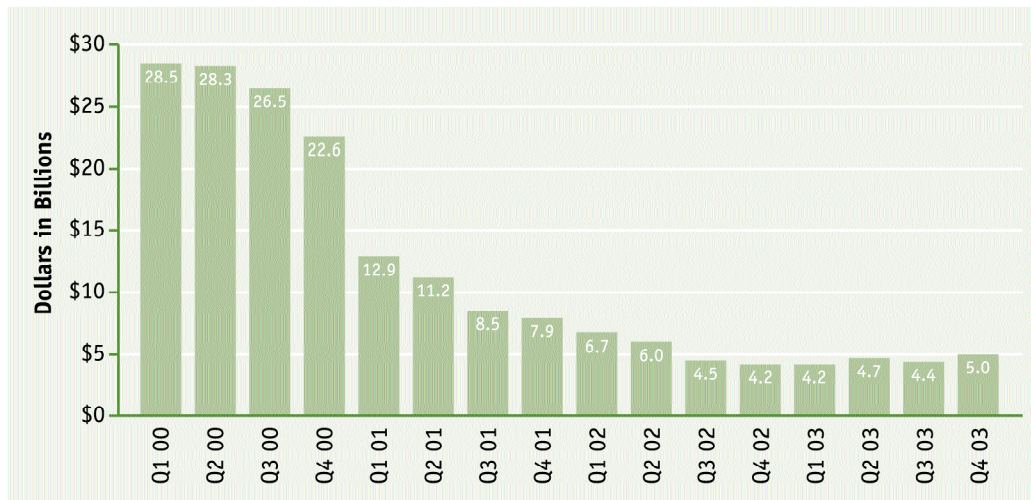
- ▶ *Seed financing "is a relatively small amount of capital provided to an inventor or entrepreneur to prove a concept and to qualify for start-up capital. This may involve product development and market research as well as building a management team and developing a business plan, if the initial steps are successful." (By this definition, pre-seed financing would denote financing to help articulate the concept.)*
- ▶ *Start-up financing "is provided to companies completing product development and initial marketing. Companies may be in the process of organizing, or they may already be in business for one year or less, but have not sold their product commercially. Usually such firms will have made market studies, assembled the key management, developed a business plan and are ready to do business."*
- ▶ *Early- or first-stage financing "is provided to companies that have expended their initial capital (often in developing and market testing a prototype) and require funds to initiate full-scale manufacturing and sales."*
- ▶ *Expansion financing is second and subsequent investment rounds typically financing company product and/or market expansion, or keeping the company financially healthy shortly before a liquidity event such as an initial public offering (IPO) or acquisition.*

<sup>5</sup> Jeffrey E. Sohl, "The Private Equity Market Gyration: What Has Been Learned?" *Venture Capital: An International Journal of Entrepreneurial Finance*, Vol. 4, No. 4, 2002, pgs. 267-274.

**TABLE 1**  
Equity Capital Sources for Entrepreneurs

STAGE	PRE-SEED	SEED/ START-UP	Funding Gaps:	EARLY	LATER
Source	Founders, Friends and Family	Individual Angels		Venture Funds	
Investment	\$25,000 to \$100,000	\$100,000 to \$500,000	1. Between \$500,000 and \$2,000,000; 2. Between \$2,000,000 and \$5,000,000	\$2,000,000/ \$5,000,000 and up	

**GRAPH 1<sup>6</sup>**  
National Venture Capital Investments, 2000 - 2003



The relatively new funding gaps of \$500,000 to \$2,000,000 and most recently also \$2,000,000 to \$5,000,000, combined with the fairly recent precipitous drop in overall venture funding, has created a domino effect of problems for early-stage companies, particularly for companies in late “start-up” or “first-stage financing” phases of critical growth and momentum. Angel groups can be a solution.

Few individual angels can accommodate the increased dollar needs of growing entrepreneurial companies, particularly in the \$2,000,000 to \$5,000,000 range, before venture capitalists are considering investments, and at a time of critical growth for a young company. But, by combining resources of individual investors, angel groups can be the proverbial white knights. Funding this second gap of \$2,000,000 to \$5,000,000 typically requires a co-investment strategy, and angel groups can be a potential solution through the combined funding resources of a group of individual angel investors. These groups also have the combined manpower for analysis of multiple or complex investment opportunities, further aiding in making these investments possible.

<sup>6</sup> Source: National Venture Capital Association



**TABLE 2<sup>7</sup>**

Venture Capital Funds, 1995 - 2003

YEAR	TOTAL (BILLIONS)	DEALS	PER DEAL (MILLIONS)
1995	\$7.7	1,874	\$4.1
1996	\$11.5	2,612	\$4.4
1997	\$14.8	3,185	\$4.6
1998	\$21.3	3,695	\$5.8
1999	\$54.3	5,608	\$9.7
2000	\$105.9	8,082	\$13.1
2001	\$40.6	4,600	\$8.8
2002	\$21.4	3,035	\$7.1
2003	\$18.2	2,715	\$6.7

**TABLE 3<sup>8</sup>**

VC Seed and Start-Up Financings, 1999 - 2003

YEAR	SEED & START-UP TOTAL	PERCENT OF TOTAL VC FUNDS	SEED & START-UP DEALS	PERCENT OF TOTAL VC DEALS
1999	\$3.3 billion	6.1%	809	14.4%
2000	\$3.0 billion	2.9%	672	8.3%
2001	\$767.0 million	1.9%	251	5.4%
2002	\$352.0 million	1.7%	155	5.1%
2003	\$354.0 million	2.0%	166	6.1%

<sup>7</sup> Source: National Venture Capital Association<sup>8</sup> Source: National Venture Capital Association

## FUNDAMENTALS

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At first glance, angel groups come in as many shapes, sizes, styles, and structures as flavors of jellybeans. But one factor does appear to be relatively constant: recent surveys of angel groups by the Center for Venture Research show that one of the primary criteria for membership is net worth or **accredited investor status of the group members**. Another constant and part of the definition that separates angel groups from other investment vehicles is the **active participation of angel group members in the investment of their own capital**. In contrast, venture capital funds, broker-dealers and investment bankers typically operate on a passive investor model — the individual is not actively involved in the investment decision-making process.

From this definition of active investment of one's own capital, an angel group is, then, a group of angel investors investing through a member-directed investment process. The actual investment direction process may vary considerably, but all members have input either through their individual decision to invest or as a member of the group to invest part of the group's fund. Angel organizations can be everything from an informal group of individuals who conduct cooperative due diligence to a group with paid management and committed investment funds.

*Any successful angel group needs to address several issues:*

**Accredited Investors:** Angel groups can self-select by numerous criteria, including industry focus, gender, or other variables. But as statistics support, substantially all of the group's members should be "accredited investors" (see previous definition). The words "should be" are purposely used because there are few regulations regarding the structure or membership criteria for angel organizations. These requirements come into play, however, at the time of investment. Companies typically refuse investors that do not qualify as "accredited investors," in large part because of regulatory information-disclosure and reporting requirements and the funding limitations imposed upon companies for acceptance of investments from non-accredited investors. Again, this does not mean that your members must be accredited investors, but entrepreneurs will have less incentive or interest in presenting to your angel organization or going through the arduous steps of due diligence with a group that has only a minimal percentage of accredited, and thus potential, investors.

The accredited investor status requirement also relates to deal flow for your angel group. If your organization is known for having active investors, high-quality potential investment deals are more likely to seek out your group for investment opportunity. In addition, accredited investors are often previously successful entrepreneurs, which is consistent with survey results showing that two other important criteria for membership are past investment experiences and member referrals of investable companies.

**A Champion:** A key factor in the success of an angel organization is an appropriate and active champion. One cannot over-emphasize the importance and necessity of an individual or small group of people to champion the establishment and instigation of your angel organization. Often, the desire of those forming the angel group will influence the structure of the ultimate organization. They will also likely be the source of other members with similar interests and confidence in your champion or founding group. Advisors are also extremely important, but an organization cannot get off the ground and succeed without a leader. Ideally, the champion or group of champions should be accredited investors with influence and connections within the community sufficient to attract other accredited investors as potential group members.

**TABLE 4**  
Angel Investor Reasoning

QUESTION	TOP THREE ANSWERS
What do you think are the main reasons that business angel investors do not make more investments?	<ol style="list-style-type: none"> <li>1. Lack of business proposals that match their general investment criteria</li> <li>2. Lack of faith/trust in company founder/management</li> <li>3. Lack of quality business proposals</li> </ol>
Which of the following reasons do you think motivate your investors most to invest?	<ol style="list-style-type: none"> <li>1. The opportunity to co-invest with other, more-experienced investors</li> <li>2. The opportunity to learn from successful business angels</li> <li>3. More trust in company founder and management</li> </ol>
More specifically, additional knowledge on which of the following stages of the investment process will motivate investors to invest?	<ol style="list-style-type: none"> <li>1. Due diligence</li> <li>2. Pricing and structuring deals</li> <li>3. Negotiating deals</li> </ol>

### **Clear Reasons for Forming the Angel Group:**

Along with having a committed individual or group, an understanding of why people become angel investors, or conversely, why they shy away from angel investing, can be critically important in attracting members. Understanding your community is also essential, and you should evaluate your community's capacity to support an angel organization. As to reasons for becoming or not becoming an angel investor, we look at the results of the CVR 2003 angel group survey. Several questions were posed to existing angel organizations relating to angel investments. The results are telling as to why the number of angel organizations is on the rise. Table 4 lists the survey questions and the top three responses from angel groups.

Although these questions were asked of existing angel organizations, the reasons for establishing an angel group are the same, and the responses give good insight into the reasons more angel groups are being formed. Along with providing the social aspects of group interaction, angel groups typically fulfill many of the needs of individual angel investors and the limitations associated with solo angel investing, including:

- Angel groups provide more efficient matching of entrepreneurs and investors. Market recognition of an angel group and its particular investment focus leverages this public presence and creates a network of members to increase quality deal sourcing and comprehensive due diligence.

- ▶ The efficiencies of group due diligence and investment support cannot be emphasized enough. Individual deal screening is time consuming and inefficient. Few, if any, individual angel investors possess all the skills and knowledge necessary to accurately and objectively evaluate an investment opportunity. Group evaluation allows for “checks and balances” analysis by providing multiple points of knowledge about the market, management, and financial assumptions, and by encouraging group members to challenge assumptions and opinions in a way not typically done by individual investors.
- ▶ New angels can learn from experienced angel investors on all aspects and steps of investing.
- ▶ The combination of potential investment dollars either through an actual angel fund or through collective individual investors gives greater economic power and influence, which enhances deal flow and investment-terms negotiation.
- ▶ Angel groups provide the intangible values of camaraderie and sharing of common goals.

Make sure that your angel group plans include a clear set of reasons for establishing the group and that these reasons fit with prospective member expectations and interests. Consider many of these attributes outlined above in defining your vision, goals, and strategies.

### **Understand Why Your Colleagues Are Interested in Being Angel Investors:**

Even more basic than the question of why investors join angel groups is the question of why people become angel investors. One noted publication<sup>9</sup> ranks the motivations for angel investors in the following order of importance:

- ▶ Expectation of high financial reward.
- ▶ Playing a role in the entrepreneurial process.
- ▶ Fun and satisfaction of being involved in an entrepreneurial firm.
- ▶ Creating a job for oneself, and possibly some income.
- ▶ Sense of social responsibility.

Along with contributing to group learning and dynamics, angel organizations can also fulfill the motivations of individual angel investors. All these factors should be considered and constantly reviewed to ensure the success of any angel organization. Understanding the fundamental psychology of angel investors will bode well in structuring your angel group.

<sup>9</sup> Robinson, R.J., and Van Osnabrugge, M., “Angel Investing: Matching Start-up Funds with Start-Up Companies” *The Guidebook for Entrepreneurs, Individual Investors, and Venture Capitalists*,” Jossey-Bass Inc. 2000

**Understand the Risks:** The advantages and potential rewards of angel investing can be desirable and financially satisfying. Despite the fact that this Guidebook is intended to support and guide the establishment of angel organizations that best suit a community and group-investment focus, one must also be cognizant of the downsides of angel investing. Angel investing is a high-risk game. Angels typically invest at an early stage of company development, when the future is on paper and in the founder's dreams rather than in the bank. Angels also have some of the greatest potential for gain. Regardless of the outcome, however, all angel investors must be willing and able to risk the loss of their entire investment. Return on investment can often take several years, if it happens at all. This seemingly negative discussion is not intended to deter your endeavors to establish an angel investment organization but rather to ensure a good foothold in reality.

## BUILDING THE FRAMEWORK (CREATING YOUR ANGEL GROUP)

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Now for the hard part: selecting the right organizational, management, and membership structure for your group. You have many variables to consider, and it is important to establish some context and framework in order to make informed choices. The following decision-making matrix is intended to lead you to a comfortable and satisfactory answer for your prospective members and community.

With each step, background points will be laid out, numerous questions will be posed, pros and cons will be given, and reality points will be identified. Of course, the ultimate test is acceptance by your members. This Guidebook also describes a few existing angel organizations with different structures that have successful track records in attracting members and making investments. In addition, several initial documents are offered in the appendices as examples of working documents for your organization and are intended to be useful for multiple organizational structures.

As you go through the process of building your angel organization, keep in mind the following almost universal truisms:

- ▶ Angel organizations are generally **made up entirely of individuals**, although some groups do have entities such as venture funds and corporate sponsors as members. Entities typically have a different status, such as associate members. One of the concerns for any angel group is that membership becomes mostly sponsors, service providers, and people who are interested in observing, but not investing. Steps to avoid this migration in membership will be discussed later.
- ▶ Angel organizations represent an **active, rather than a passive, investment process**. Members are engaged in some way throughout the investment process. Individuals seeking only passive investment opportunities should consider venture capital funds or a private equity manager.
- ▶ The groups are made up of **individuals with common interests**, typically early-stage investments. Some groups, particularly in larger cities, may have an industry or market focus. This can influence potential membership by appealing to both those who would be attracted to your angel organization because of the particular focus (but do not necessarily have any background in the focused market) and those who you would be interested in joining your group because of their background and experience.

- ▶ Members have a **mixture of experience and backgrounds**, not only in particular industries, but also in professional skills such as management, finance, marketing, human resources, or research. Having members with different professional backgrounds can be critical in conducting due diligence on potential investment opportunities.
- ▶ With a few exceptions, **angels prefer to invest locally**. The reasons are several: from an interest in giving back to one's community, to ease of performing due diligence on the company, to interest in an ongoing relationship with the company and management.
- ▶ As discussed previously, but worth repeating, a successful **angel group must have a champion** or group of champions to ensure successful establishment and operation.
- ▶ Group members value angel group dynamics, the opportunity to learn from one another, and **access to superior deal flow**.
- ▶ Last, but definitely not least, a primary reason that individuals become angel investors is a **keen interest in capitalizing on high-return potentials**. We have already discussed maintaining a strong hold on the reality that angel investing is a high-risk proposition, and we must remind ourselves at each step that angel investors must be willing and able to lose their entire investment in the high-risk, adrenaline-pumping game of early-stage financing.

## COMMUNITY ASSESSMENT

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The first step in establishing an angel investment organization is to conduct a community assessment to better understand the nature of your investment community and potential group members. Assessments must be made in an objective manner. The very fact that you are reading this Guidebook indicates your interest in establishing an angel organization. However, you must be conscious of community limitations or industry focus that could hamper your attempt to establish a vibrant angel group or that might limit the type of investments available and, as a result, limit your membership.

The following table gives you categories for evaluating available data and general information in making your community assessment. No one community will have all these attributes. Nor will you find the relevant data for all categories. The more valuable part of this exercise is actually conducting an objective analysis of your community to identify community strengths and weaknesses in considering the viability of an angel group. You may find that, although important attributes are missing, your community is strong in other areas or has the means to develop those missing aspects. You may be able to complete the assessment with your local entrepreneurial-support community and without paying for an outside consultant.

**TABLE 5**  
Community Assessment  
Questions and Process

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
<p><b>Potential angel community</b></p> <p>Does your community have sufficient numbers of accredited investors to form a viable group?</p> <p>Is there a sufficient core of experienced investors or other resources to help with educating nascent angel investors?</p>	<p><b>Review census reports, home values, and number of successful industries</b> (correlates to successfully exited executives). It may also be informative to compare your region to other parts of your state to understand any trends and stability in your region's wealth population.</p> <p>Along with the need to have a solid population of potential members is the need to have members who can share their experiences and expertise with new members. Angel investing is more sophisticated and involved than early investment dollars coming from friends and family, who typically invest out of affection and familiarity. Therefore, your members need the ability to have initial and ongoing education and training to improve potential investment performance and long-term return, thus creating a successful angel organization.</p>	<ol style="list-style-type: none"> <li>1. Does your community have a strong presence of wealthy individuals, especially those who have made their money through building their own successful company?</li> <li>2. Does your community have a number of public company corporate headquarters (which would suggest high-net-worth individuals in senior positions)?</li> <li>3. Does your community strongly support the arts and have a number of endowed organizations? (Also suggests high-net-worth individuals.)</li> </ol>
<p><b>Prevalent industries in region</b></p> <p>What established and developing industries are in your region?</p>	<p><b>Again, census information can help you better understand your community.</b> Since angels generally invest locally, you need to make a thorough assessment of your regional industries to determine whether your particular goals or interests for the angel group fit with your community. For instance, if you desire a high-tech focus for your angel group, but the vast majority of industries in your region are agricultural or traditional manufacturing, you may have difficulties creating a successful angel group. Additionally, your regional industries should represent a good mix of markets that typically need start-up and further capital, with a healthy product or services market size attractive for acquisition or IPO.</p>	<ol style="list-style-type: none"> <li>1. How does your community compare in industry base, particularly high-tech or biotech, with other communities in your state and the nation in general?</li> <li>2. Do these industries often create second- and third-tier entrepreneurs?</li> <li>3. Do your regional industries often require start-up financing, and are they able to obtain funding locally?</li> <li>4. Are the companies represented by your regional industries appropriate for liquidity events such as an IPO or acquisition by a publicly traded company?</li> </ol>



CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
<b>Entrepreneurial pool</b>  Does your community have an active entrepreneurial environment?	<p><b>Assess the number of entrepreneurial companies in your community, including the number of companies funded. Additionally, assess the ongoing likely sources of cutting-edge products or services, such as from leading colleges in various disciplines.</b> For instance, your community may have a university, with colleges in the areas of applied physics or biochemistry.</p> <p>If there are no or few viable companies for investment and few sources of innovative products and marketing concepts, it doesn't make any difference how many high-net-worth individuals may live in your community — there won't be adequate deal flow for the group. Additionally, your community must be one that generally attracts entrepreneurs because it possesses many of the attributes described in this community assessment.</p>	<ol style="list-style-type: none"> <li>1. Do you have a number of young companies starting up in your area? (Your local business trade publication is often a good indication of the degree of entrepreneurial activity.)</li> <li>2. Is your community considered healthy and thriving, as well as attractive to entrepreneurs?</li> <li>3. Does your community have centers of higher education, particularly with graduate programs in the areas of engineering, science, or math?</li> <li>4. Does your community have government-funded research centers?</li> </ol>
<b>Entrepreneurial infrastructure that supports, educates, and fosters entrepreneurs and new businesses</b>  Does your community have entrepreneurial centers and entrepreneurial education programs and associations?	<p><b>Make an assessment of the number of start-up business services and programs, as well as trade or industry associations, to get a better idea of entrepreneurial support in your region. Additionally, make an assessment of state and local tax incentives and other legislation and economic incentive programs that support and promote growth.</b> This analysis may also give you a better understanding of the prevalence of specific growth industries in your community. Even if you have a solid pool of entrepreneurs, the likelihood of developing successful businesses is diminished, or your community's potential will not be met, without an active entrepreneurial support system.</p>	<ol style="list-style-type: none"> <li>1. Do you currently have, or would there be an interest in conducting, regular entrepreneurial investment forums, business-plan competitions, and similar programs?</li> <li>2. Do your community educational institutions have graduate-studies programs in business, and do they support entrepreneurial programs such as business-plan competitions?</li> </ol>

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
	<p>Often, experienced, cashed-out entrepreneurs will volunteer with entrepreneurial programs as mentors, program managers, or trainers as a way to give back to their community and stay involved. Investment forums can also be a terrific mechanism for highlighting the cream-of-the-crop companies seeking financing, since these forums typically have a selection committee to choose the companies to present, as well as a coaching team for each selected company.</p> <p>The political and business environment must also be conducive to the growth of young companies. Active Economic Development Councils, Chambers of Commerce, and state legislators can be critically important and essential. Even the presence of a strong business journal can be an indicator of a healthy environment that fosters entrepreneurship.</p>	<p>3. Are there trade industry associations in your community to support and foster existing and new companies, such as companies related to software or biotechnology?</p> <p>4. Are there non-profit organizations in your community with a specific mission to support and foster the growth of entrepreneurial businesses, such as MIT Forum or Young Entrepreneurs Organization (YEO)?</p>
<p><b>Support services/teams</b></p> <p>Does your community have a solid pool of experienced service providers and potential senior management?</p>	<p><b>Review professional source guidebooks, and analyze the number of firms and individual professionals that list services and skills relevant to early-stage companies. Assess the talent pool for key team positions such as CFO, CTO, or CSO by reviewing the presence of regional graduate programs and professional association memberships and by analyzing existing business human capital shortfalls.</b></p> <p>Without excellent professional support, bright and ambitious entrepreneurs may struggle to create a solid company, placing your investment capital at greater risk. In addition, investment-grade companies are not made up of a single individual, and the presence of key talent is critical to a successful company. Any entrepreneur who believes he or she can do it all is someone you want to shy away from, as none of us knows everything. Effective entrepreneurs recognize their limitations as well as their talents.</p>	<p>1. Is there a good base of young and/or experienced talent for key roles in companies through local graduate school programs, optioned-out high-tech employees, successful corporate managers or doctoral researchers?</p> <p>2. Does your community have legal, accounting, marketing, and other services experienced in early-stage company development and financing? Do these service providers often speak on relevant topics at various programs?</p>

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
<b>Follow-on funding</b>  Are there adequate local sources for sizable and later-stage financing?	<b>Make an assessment of regional venture capital funds, mature companies for potential partnership and funding, and banking resources for debt and capital equipment financing.</b> Many entrepreneurs will need funding past the initial angel round. As a result, additional funding sources become absolutely essential, if for no other reason than to protect your angel investment. With the recent dramatic drop in venture capital financing, some angel organizations have recognized the need to provide funding for companies past the traditional early angel round. Venture capitalists are funding fewer and fewer early-stage deals and, as a result, angel investors must either step up to further fund an investment or risk loss of their money. Of course, many businesses require funding beyond the means of most angel organizations, and available sources of subsequent funding must be known. Angel organizations that have connections to, or ongoing relationships with, venture capital funds will have the advantage of potential follow-on funding and better screening of early investments through reciprocal referrals from venture capitalists.	<ol style="list-style-type: none"> <li>1. How many VC funds are located in your community or general region?</li> <li>2. Are there smaller VC funds that may invest in earlier-stage companies?</li> <li>3. Could your angel organization support any and all financing needs, and would this fit with member interests?</li> </ol>

Keep in mind that any one community seldom has all of the attributes for supporting an angel organization, and interpretation of facts and information should be balanced against your assessment of the relative importance of the various factors in your community. Also, your prospective group may decide to lead your community in the development or expansion of certain activities, such as entrepreneurial support services or investment forums. Therefore, the community

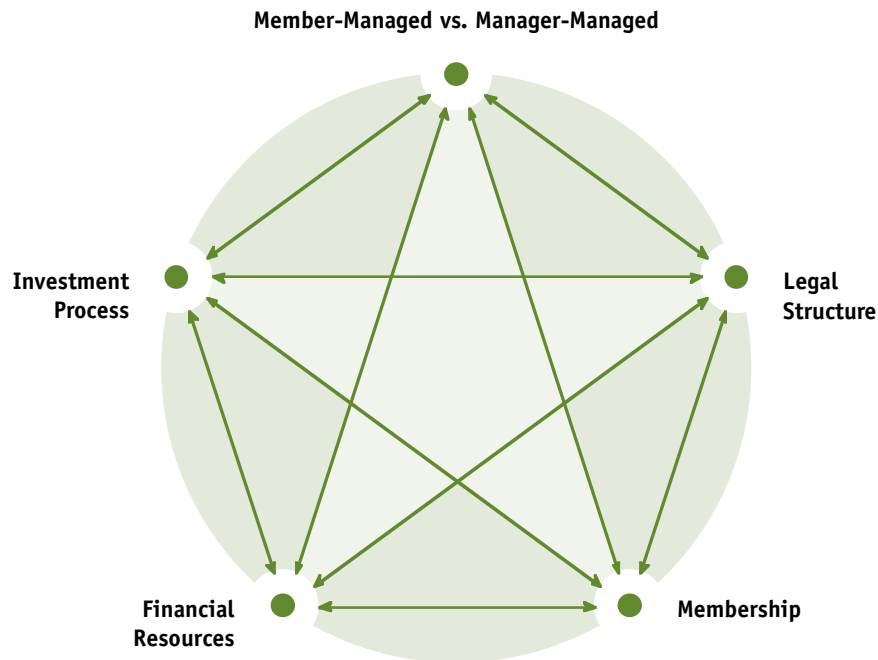
assessment is really intended to give you a better understanding of the potential for success of your angel group and, possibly, also determine the best investment focus for your organization.

Now that you have completed your community assessment and determined that your community has many of these attributes, it is time to move on to the development of your angel organization.

## SELECTING A STRUCTURE

A first step in setting up an angel group is determining the right organizational structure for your community and group members. The following matrix emphasizes the interdependency of your various choices or decisions related to the structuring and operation of an angel group. Nearly every decision you make can affect previous assumptions or decisions. As such, continue to challenge your previous choices or decisions for fit and appropriateness with each step. Keep in mind the following:

**FIGURE 1**  
Decision Matrix



- ▶ **There is no one best model for angel groups.** The angel organization “industry” is still in its infancy in many respects, and only limited research and evaluation have been conducted to date. As a result, one cannot draw any conclusions about the superiority or success of one particular model. In fact, anecdotal evidence suggests that many models have been successful (if we can even agree on the measure of success).
- ▶ **Form must always follow function.** Do not choose a particular legal model or management structure and then try to shoehorn your members into a model that does not fit their interests or investment orientation. Let your members’ interests and comfort levels guide your ultimate decisions.
- ▶ **Remember to keep your knees bent and challenge your previous decisions.** As much as you would like the process of angel group development to be straightforward, your willingness to listen to input and adjust previous assumptions will bode well in creating a successful organization.

## DECISION STEPS

### MEMBER-MANAGED VERSUS MANAGER-MANAGED

One of the fundamental decisions to make is whether your organization will be managed by the members or by a professional manager. By its very description, a member-managed (or member-led) organization requires active member involvement in nearly all aspects of operation. Member-led organizations usually hire administrative support to handle matters such as member communications, meeting coordination, and database maintenance.

In contrast, a manager-managed (or manager-led) organization employs the services of an individual(s) with experience and background in the investment process and/or in the industry in which the angel organization intends to focus its investments. Typically, a manager does much of the up-front work of vetting possible deals, conducting initial interviews with companies, coaching entrepreneurs for presentation to the angel group, handling member communications and relationships, and even at times making recommendations on investments and negotiating investments on behalf of the organization.

**TABLE 6**  
Structural Pros and Cons

MANAGER-LED	MEMBER-LED
<b>Pros:</b> Professional operation; screening and investment activities conducted by experienced management; manager handles member relationships	<b>Pros:</b> Greater connection of members to group and activities such as deal screening, member recruitment, etc.; involvement provides for hands-on education for members
<b>Cons:</b> Operating costs are higher to cover professional management income, benefits, office space, and administrative support	<b>Cons:</b> Ability to maintain consistent volunteer commitment of members; potentially inconsistent operations

This manager is not the same as a general manager of a venture capital fund, which has the authority and control over all investment decisions. Instead, an angel group manager manages the group's processes so that the members can focus on making investment decisions.

Some of the pros and cons of these two basic structures are illustrated in Table 6.

**STATISTICS ON STAFFING:** *In reviewing the results of the 2003 CVR survey of angel organizations, the majority (61%) of responding organizations had paid professional staff. Interpretation of this percentage is difficult because organizations with paid management may be more likely to respond to a survey and because the interpretation of "paid manager" may differ between groups. However, if you take into consideration the number of affirmative answers regarding the prevalence of paid management, along with the presence of an executive director and/or administrative staff, most organizations answered in the affirmative. Again, the exact percentage is a bit difficult to calculate because of the uncertainty of individual interpretation of terms and the rate of responses between organizations with structured management (even if only administrative support). As will be discussed later, several factors will influence your decision on staffing, including the organization's legal structure and budget (and how you finance your group).*

The following questions will help you make the fundamental choice between a member-led or manager-led organization. Keep in mind that even with member active participation in some or all duties and organizational activities, a manager may still be quite appropriate, particularly with large groups (more than 75 members);

many groups with actively participating members have executive directors, and nearly all have some type of administrative support. A more detailed discussion of various group activities and duties is under “Operations” in this Guidebook.

**TABLE 7**  
Member-Led versus Manager-Led Groups

QUESTIONS	YOUR ANSWERS (1 or 2)*
1. Are members interested in reviewing all applications for presentation to the group, and do they have the time to do so?	1 or 2
2. Are members interested in coaching companies for presentation to the group, and do they have the time to do so?	1 or 2
3. Do members prefer to make all decisions on, and have direct involvement in, operational structure, membership interaction, Web site content, public relations, and budget?	2
4. Will members be willing to contribute time on a regular basis to the executive and/or operational management of the group, including board activities, committee work, membership recruitment and relations, deal screening, due diligence, and negotiation of investments?	2
5. Are members not willing to pay for professional staff, which can be a significant expense, in addition to covering the operational costs?	2
6. Would members prefer to have responsibility for conducting many of the activities related to operating a successful angel organization, including member recruitment, meeting planning, deal sourcing, deal screening, due diligence, and investment negotiation? Do members have the background and expertise to conduct these activities?	2
7. Would members prefer to hire administrative support staff to handle communications and meeting planning, but leave other functions up to members?	1 or 2
8. Do you plan to operate your organization as an angel fund, with member-committed investments? If no, managers are not necessary, although even some organizations in which members make individual investment decisions have paid professional managers. Some member-determined investment groups will also have a sidecar fund, or a fund that invests alongside investments that may be made by the angel organization. Again, this type of angel group would be well served by professional management. If yes, a manager-led organization is probably more appropriate because of the need to coordinate handling of investments. Additionally, a strong manager is typically a deciding factor for individuals considering membership and commitment of personal funds.	1 or 2 (see discussion)

**Examples of manager-led and member-led organizations:** Since this first decision point in your group development process is so important, an example of each structure may be valuable to get a better understanding of your choices.

An excellent example of a **manager-led** organization is **CommonAngels in Boston, Massachusetts** ([www.commonangels.com](http://www.commonangels.com)). The organization has an angel group of approximately 50 members, who make individual investment decisions. In addition, CommonAngels has a sidecar investment fund (i.e., a committed investment fund related to the angel organization that invests through a separate investment committee). An office manager and associates (often MBA students) support the managing director. This is a structure that supports a larger, more diverse organization and provides the manager the ability to give attention to the big picture as well as to details regarding member communications and recruitment, deal screening, due diligence, investment negotiation, and investment follow-up. Such a staff is an investment that needs to be aligned with your organizational needs and investment strategy. Much of the value and benefit of a manager-led organization comes from the combination of management skills and experience previously discussed, which CommonAngels most definitely possesses.

When we talk about **member-led** organizations, **Tech Coast Angels in Southern California** represents an effective operation. Volunteer members manage the strategic as well as the day-to-day operations of Tech Coast Angels. Members are invited and encouraged to attend deal-screening meetings, which occur twice a month, with member attendance averaging 40 to 60% at each screening meeting. All intrinsic parts of the investment process are done by members, with support from part-time administrative or professional support of a deal-flow administrator and screening director, who handle investment mechanics such as assisting entrepreneurs in completing applications, arranging meetings, etc. Members are experienced entrepreneurs who have been through it all, making them knowledgeable investors and potential mentors. In fact, about two-thirds of members have CEO experience. Tech Coast Angels has three chapters in San Diego, Orange County and Los Angeles, and the entire Tech Coast Angel network shares deal flow, expanding the investment-opportunity pool for members.

**Finding the right manager:** If a manager-led model fits your functional intentions and is aligned with member needs and interests, you should carefully consider desired manager attributes. Cohesiveness between the manager and your angel group can be the single most important factor in the success of your organization. As such, consider the following combination of skills:

- ▶ Business expertise and savvy;
- ▶ Financial intuition;
- ▶ Motivations parallel to those of the group;
- ▶ Domain or investment-focus expertise;
- ▶ Organizational operation insight;
- ▶ Communication skills and diplomacy;
- ▶ Leadership qualities; and
- ▶ Process-management skills.

Interestingly, these skills also are considered important in entrepreneurs, and should also be part of your due diligence review of management.

Remember that a manager is more than administrative support. The manager should be a leader, coordinator, decision-maker, spokesperson, and den mother for your angel group. Many angel groups prefer to retain these roles in its members and may choose to employ an executive director, who typically handles member relationships, communications and other operational matters, but plays a minimal role in the investment process. Certainly some of the skills listed, particularly the second half, would be valuable skills for an executive

director. Many groups may have only administrative staff to coordinate meetings and communications, and all other functions are left to members. As has been stated before and will be repeated throughout this Guidebook, any of these models is perfectly acceptable and viable; the final choice depends entirely on your needs and member interests.

## LEGAL STRUCTURE

Multiple legal structures work for both member-led and manager-led organizations. The preferred structure will again depend on your group's desired complexity and level of member involvement, as well as appropriateness for your community. Member familiarity with a particular structure and the angel investment group concept may be factors in legal-structure choice. The five currently prevailing angel organization legal structures are:

- ▶ **Affiliation without Formal Structure:** A loosely affiliated organization is appropriate for member-led groups, particularly those with a smaller number of members and/or early in their operation. Informal groups usually work well up to around 15 members, when more structure is needed for basic operations. Part-time administrative staff may be helpful to handle matters such as member communications and meeting logistics. Generally, these groups have regular meetings, with any and all investment decisions made on an individual basis. Members usually are active in all aspects of the group, from screening business plans to membership recruitment.



Obtaining financial support for informal groups can be challenging, depending on the desired level of sophistication. Costs can include items such as member communications and information management, meetings, and due diligence. Typically, cost coverage must come from the members, with the advantage that costs are usually relatively low because of the lack of formal structure and limited membership. No particular documentation is necessary, but the group may wish to have some agreement or code of conduct between members requiring that they respect one another's confidences. Additionally, decisions regarding membership should be made through group consensus to maintain the desired culture and intimacy of the group.

Informal groups work best with a small number of members. When membership grows, structure becomes a necessity to handle group issues and operations. Affiliations work well as a first step when introducing the concept of organized angel investing to a community. Individuals may have trepidations about plunging into a highly structured organization or actual angel fund, and they may prefer to build a trust level before developing a more formal organization. Similarly, some investors are fiercely independent and private about their investment decisions, and while they appreciate and enjoy group camaraderie, they consider the actual investment choice and process to be their own business. For these investors, an affiliation is a good choice.

#### AFFILIATIONS MAY BE BEST FOR:

- ▶ *Small groups (fewer than 15)*
  - ▶ *Getting started, before membership is fully identified and uncertain as to group desires and needs*
  - ▶ *Each member desires to remain independent in all aspects of investment process*
- 
- ▶ **Nonprofit Corporation:** Many organizations that start out as informal groups to test member interest will migrate toward a more formal structure. As discussed above, this is particularly true when the group grows and adds members. The nonprofit corporate structure allows for easy establishment of formal decision-making processes for handling group dynamics and operations through a governing board. The nonprofit structure, as with other formal structures discussed below, facilitates the establishment of banking accounts and the hiring of staff and enhances the group's ability to enter into contractual arrangements.

The term “nonprofit” generally refers to a corporation formed under a state nonprofit corporation statute. Typically, nonprofit organizations are either mutual-benefit entities, such as private clubs, which exist for the benefit of their members, or public-benefit entities, such as community food banks, which exist for the public benefit. States generally have one statute that governs for-profit corporations and another that governs nonprofits. Thus, state law determines the nature of the entity to be formed and governs its day-to-day operations.

A “tax-exempt” organization is one that the Internal Revenue Service (IRS) has recognized as meeting certain tax-law requirements for exemption from federal income tax. Most tax-exempt organizations are nonprofit corporations or charitable trusts. The fact that an organization is formed as a nonprofit corporation under state law does not make it tax exempt. With minor exceptions, an organization must file an application for federal tax-exempt status with the IRS and receive a “determination letter” granting the exemption. The application is made on IRS Form 1023 (for Section 501(c)(3) organizations) or Form 1024 (for other organizations). The Internal Revenue Code grants an exemption from federal income tax to more than 25 different categories of organizations, with the most prevalent sections for angel organizations being 501(c)(3) or 501(c)(6), educational pursuits or trade associations, respectively. Donations to 501(c)(3) organizations are tax deductible, while donations to

501(c)(6) organizations are not tax deductible. This brief discussion of tax-exempt organizations should not be interpreted as minimizing the considerable requirements to qualify for a tax-exempt status. As with development of any organization, one should consult a professional skilled in the area.

As evidenced by the statistics outlined below, nonprofit organizations have been a frequent choice for angel groups. To obtain tax-exempt status, an organization must fulfill tax-code requirements for purpose and structure and then remain consistent with them to maintain the status. These requirements can be restrictive for some groups, particularly those intending to invest through the group organizational structure. This may also be an unworkable structure if you desire to compensate the group manager or others through a portion of the investment, sometimes called the “carry.”<sup>10</sup> On the other hand, tax-exempt status is well suited for groups in which individual members make their own investments and the angel group exists to promote the group’s purpose or to educate its members and others on angel investing.

The **Sierra Angels** is an excellent example of a 501(c)(6) organization. Soon after launching the angel group in the **Lake Tahoe area of Nevada**, the members discovered a lack of regional management talent and skilled labor. In addition, there were few links between the business, education, and research communities, and limited access to venture capital

<sup>10</sup> You may still be able to make this work later if all investments are made (and carry given) through a structure separate from the operational organization. As mentioned, consult a professional for advice on structure.

and lending sources. As a result of these deficiencies, Sierra Angels expanded their charter in order to play a key role in the economic development of the region. Today, Sierra Angels is definitively involved in many aspects of educational development and economic diversification in Nevada. These educational activities provided the ability to file for and receive a 501(c)(6) tax-exempt status.

Examples of member activities include: participation in the drafting of the master plan for University and Community College System of Nevada; participation in the development of the University of Nevada-Reno Strategic Plan; active members on the advisory boards for the Colleges of Engineering and of Business Administration for the University of Nevada; Nevada Center for Entrepreneurship and Technology (a public/private corp.); Golden Capital Network; and trustees for the Sierra Nevada College, helping the college become a distinctive, focused, liberal arts college with prominent majors in entrepreneurship, computer science, entertainment technology, and environmental science and policy.

Another excellent example is **Angel Healthcare Investors, LLC**, in **Boston** which, like so many other angel groups grew out of the founders' common professional background and their mutual interest participating in early-stage investment opportunities, through a community of collegial, well-connected and talented health-care professionals with a desire for yield of economic and social benefits. By developing

clear processes and systems (some of which will be discussed later in sections about deal flow and investment), supporting an emerging culture and building traditions, and educating and communicating both within the group and in the marketplace, AHI has become an innovative, responsive, cohesive, and respected angel organization. All investments are made through separate one-time investment vehicles, which, in AHI's case, is a new LLC for each investment (as opposed to individual participants writing checks directly to the company). Each investment then has a designated portfolio monitor — either a staff person or a group member — to observe the investment and report back to the group.

#### NON-PROFIT ANGEL GROUPS MAY BE BEST FOR:

- ▶ *Nearly any group other than an angel investment fund in which members share in investment profits and losses through the fund structure*
- ▶ *Even with angel funds, group operations may be supported through a non-profit structure, and investments can be made through separate legal structures such one or more LLCs*

► **Limited Liability Company:** LLCs are emerging as a popular legal structure for angel organizations. LLCs are more complex in operation, with capital accounts and profit/loss distributions, but they do provide a number of benefits. Individuals can be members of the LLC, with one or more managing members. Officers can be elected just as with a traditional corporation. LLCs can have a board (sometimes called a “Board of Managers”), which functions much like a corporate board of directors and serves many of the same purposes of operational oversight, strategic planning, and approval of certain organizational matters. The LLC structure provides considerable flexibility in membership (both individuals and entities can be members) and has the possible benefit of being taxed as a partnership. The structure works well for both manager-led and member-led organizations, with statistics showing a fair balance between these two management structures. LLCs are particularly well suited for angel groups that require an up-front commitment of capital from members and then make investments through the fund (as opposed to individual investments). A few angel groups create separate LLCs for each investment, with the LLC members being those members of the angel group choosing to participate in that investment.

#### LLC STRUCTURES ARE BEST FOR:

► *Angel investment funds, although the structure can be used for any angel group. As noted above, LLCs have a more complicated tax structure with a partnership taxation structure, so if your group intends to have individual members make their own investments in portfolio companies (i.e., no pooled or combined funds for investment), a simpler structure such as a non-profit corporation may be best*

**The Washington Dinner Club (Washington, DC)** demonstrates the success of a manager-led limited liability company (LLC). The Dinner Club was formed by two regional investors who successfully established three such groups. This angel group structure allowed for two classes of membership interest — one for individual investors with one vote per member and a second class for institutional investors, which had no voting rights. In the third Dinner Club, membership was capped at 75 individuals and 10 institutional members, with a minimum of 30 individual memberships in order to activate the LLC. Individual members were required to make an initial capital commitment of \$50,000, with a total of \$150,000 investment commitment over the LLC term. Institutional investors were required to make a total investment commitment of \$500,000 in similar increments. The Club had an operating budget (roughly calculated at 2 to 3% of total subscribed capital) for its monthly dinner meetings, support services for meetings and due diligence, accounting, and other operational expenses. Managers received a management fee from the operating budget and a 15% carried interest from any portfolio gains, on a deal-by-deal basis. The managers were responsible for the day-to-day operations of the Club, including member communications, administrative matters, and deal flow. Members participated to varying degrees in due diligence, investment terms negotiations, and post-investment relationships. Reflective of angel groups, all investments were made only upon membership approval.

► **Corporation (For-Profit) and Subchapter S Corporation:**

A traditional corporation is the legal structure of most publicly traded companies, with shareholders, boards of directors, and corporate taxation. The 2003 CVR angel group survey shows that approximately 9% of the responding angel organizations have a traditional corporate structure. A corporation can work well as the parent or holding company for more sophisticated angel organizations desiring a different entity for management functions that are separate from the investment vehicle.

Subchapter S corporations provide a group with all the functional and organizational attributes of a corporation, but with partnership tax treatment. However, S Corporations are less flexible than LLCs. In contrast to LLCs, S Corporations may have only individuals as shareholders, and only one class of stock may be issued. These limitations can create problems for members wishing to run their investment portfolio through a corporation or some other legal organization, or if you desire to have different classes of ownership, such as a different class for each investment, which will be made up of different individual members for each investment. As a result of these limitations, this structure is seldom chosen by angel organizations.

► **Limited (Liability) Partnership:** Venture capital funds are now almost universally structured as LPs or LLPs. Investment decisions are made by the general partners, with the limited partners taking a passive role, which is legally mandated for limited-liability status. Because angel groups are made up of active investors, this legal structure is seldom seen and may be present only in limited side funds (funds that operate alongside an angel group as an independent investment vehicle).

One possible use of an LP is when management is compensated through a percentage of each investment. For those groups that have a dedicated fund with long-term compensation to professional staff (i.e., “carry”) as well as individual angels participating directly in investment opportunities, an LP can serve as an intermediate vehicle between the fund and the manager to hold the carry. This intermediary gives the manager several advantages:

- Employees receive the legal benefit of a corporate shield;
- The manager can change staff over time without the complexity of swapping general partners or the manager itself; and
- Non-accredited investor employees can receive part of the carry by being members of the LP. Typically they cannot be direct participants in the fund itself without damaging its status as an accredited investor.

STATISTICS: *Looking at existing angel organizations sheds light on proven models. According to the 2003 CVR angel group survey:*

- ▶ 44% of responding groups were nonprofit and/or 501(c) organizations
- ▶ 38% were limited liability corporations
- ▶ 9% were corporations
- ▶ 7% were informal groups or affiliations
- ▶ General and limited partnerships were not favored legal structures

### **Questions for Choosing Your Legal Structure:**

*The following questions will help you choose a legal structure for your organization. Before making a final decision, however, you should obtain professional advice on this issue.*

*Q. Do you intend to require member investment commitments to create a pooled fund?*

If yes, an LLC structure would work well as the operational structure as well as investment vehicle.

If no, almost any other structure will work, depending on other factors such as the desire for greater organization (therefore, not a simple affiliation) and the anticipated level of governance of group activities. Therefore, the choices can be:

- ▶ **Affiliation without formal structure**, which is not recommended for groups with more than 15 members, due to the necessity for organizational structure, operation, and governance with larger groups.
- ▶ **LLC** can be used for all intended operational structures. LLCs provide the protection of a corporation and are taxed as a partnership. Member capital accounts and profit-and-loss allocations can be confusing, so consult a professional. Because of these various accounting and tax aspects of LLCs, some groups have used the non-profit structure (whether or not federally tax exempt) as a simpler, straightforward structure with governance attributes similar to a standard corporation. This latter point of avoiding a complex legal structure is particularly true for member-led groups.
- ▶ As discussed above, **non-profit corporations** can be a good choice for groups with individual member investments. A non-profit would not be appropriate for a fund or group that intends to invest through the group legal entity and/or distribute returns through the entity, since non-profits cannot provide shareholder benefits. Whether or not your group files for tax-exempt status is another level of decision-making that involves making real, conscious choices about group focus and mission.
- ▶ **C corporations or Subchapter S corporations** can also be used but do not provide any special benefit outside the other structures.

*Q. Would members prefer little or no structure, and do you intend to keep membership to a small, intimate group?*

Table 8, on the following page, gives a summary comparison of the various legal structures.

If yes, a simple affiliation can be appropriate.

If no, consider other priorities for your group, such as:

- ▶ A need or desire to have a tax-exempt structure to avoid any tax issues, which suggests a **501(c)** structure, assuming the organization's operational purpose and other relevant factors align with requirements for obtaining and maintaining tax-exempt status.
- ▶ Members' desire to have considerable input on operational matters. Along with suggesting a member-led rather than a manager-led organization, significant member involvement can be accomplished through any of these legal structures. An **LLC or non-profit corporation** can provide for member involvement, although typically a smaller set of individuals act as the managing members or board of directors, respectively. As noted above, **LLCs** work well for manager-led funds, even with group members desiring active involvement in group management or governance, since the manager can be designated as the managing member or given other designated authority, with angel investors making up the board of managers.

**TABLE 8**  
Legal Structure Comparison

FACTOR	LIMITED LIABILITY COMPANY (LLC)	NON-PROFIT CORPORATION	501(c) TAX-EXEMPT ORGANIZATION	C CORPORATION (STANDARD)	S CORPORATION	LIMITED PARTNERSHIP
<b>TYPICAL investment model</b>	Investment fund (can be used for member-determined investment groups)	Member investments (can be a separate or parent entity for group operational purposes, with a separate entity as an investment fund)	Member investments (can be a separate or parent entity for group operational purposes, with a separate entity as an investment fund)	Member investments (can also be the management vehicle with a side fund for group investment)	Member investments (could also be used as an investment fund, but limited to one class of stock, and only individuals may be shareholders)	Rarely used, typical VC structure
<b>Liability</b>	Limited	Limited	Limited	Limited	Limited	Limited for limited partners, liability for general partners
<b>Governance</b>	Board of Managers	Board of Trustees/ Directors, depending on whether a public-benefit or mutual-benefit organization	Board of Trustees	Board of Directors	Board of Directors	General partners
<b>Taxation</b>	As a partnership	At corporate level (as non-profit corporations cannot have shareholders)	No tax consequences and no shareholders	At corporate level or double-taxed on dividend distribution	As a partnership	As a partnership
<b>Membership</b>	No limit on member numbers generally. If a fund, the operating documents often have a maximum number of members relating to fund size	No limit on member numbers; no shareholders in non-profit, therefore not appropriate as an investment vehicle (look to LLC or for-profit C corporation if desire group investment structure)	Same as non-profit corporation	Members may also be shareholders, and, as such, this structure can be used as an investment vehicle (but be aware of double-taxation issues)	Only individuals may be shareholders, and only one class of stock is permitted	Ownership is by general and limited partners, the latter being partially defined by their non-involvement in management and operations, thus not generally appropriate for angel groups



## INVESTMENT STRUCTURE

Angel group investments can be broken down into essentially two forms:

### *Group Investment*

- ▶ **Pooled funds** with each investment: Some groups combine the financial power of individual investments into a group or pooled investment, giving the group collective negotiation power.
- ▶ **Pledged or committed funds** are invested by group decision. Upon majority group affirmative decision, the group invests a defined amount. The investment amount can be decided by vote of committed and pledged fund members or by individual members for pledged funds. Additionally, the manager can recommend an appropriate investment amount based on company analysis. No respondents to the 2003 CVR survey required unanimous affirmative group vote for investment.

DEFINITIONS: *“Pooled funds” refers to a process in which individual members make their own investment decision, and then the group combines all member dollars into a single investment.*

*“Pledged funds” refers to member commitment of a certain dollar amount, but the money is not transferred to the angel organization until needed for investment. The amount invested can be a group decision of an investment amount, or a group may allow individuals to decide personal investment amounts, with the latter having an annual investment requirement.*

*“Committed funds” require that members place their investment amount in the fund upon membership acceptance, or in staged and timed quantities for cost coverage and investment purposes.*

Even with group investments, most organizations allow members to make additional, separate investments in companies chosen for group investment, and certainly anyone is entitled to make any investment in a company not chosen for group investment.

### *Individual Investment*

- ▶ **Based on group due diligence**, individuals can then decide if a company fits their planned investment criteria and portfolio. As with a pooled fund, individual investors can combine their funds into a single investment vehicle, such as an LLC (assuming that everyone is an accredited investor). The basic difference between this approach and the pooled funds approach is the understood intent and the group's defined investment process. In other words, with a pooled fund, group members understand that investments will be made through a group decision process, with pooled or combined funds invested into the portfolio company. On the other hand, even with group due diligence, an angel group set up to allow individual investment decisions does not have the assumption of collective investment decision or investment, but rather each angel investor makes their own decision for investment. From this individual decision, based on group (or individual) due diligence, the group can always decide to combine their investment amount into a single investment such as through an LLC.

- ▶ **Based on individual assessment**, which typically relates to fairly informal groups, or a circumstance where only one member is interested in the company.
- ▶ **Side-fund investment with individual additional investments** can work well, with the side fund conducting much of the due diligence and sometimes leading the investment.

## DETERMINATION OF MEMBERSHIP

When asked about having established membership criteria in the 2003 CVR angel group survey, all responding groups answered in the affirmative. Nearly all angel organizations require that members be accredited investors. As discussed earlier in this Guidebook, companies prefer to present solely to accredited investors to allow for qualification under regulatory exemptions from certain registration, information, and other requirements of federal and state securities laws. As a result, companies prefer to avoid non-accredited investors (for whom at least the information-disclosure requirements would apply). Therefore, angel organizations with all (or essentially all) accredited investors are more likely to attract strong investment opportunities.

One must consider numerous factors when determining the nature and attributes of membership:

### *Selection:*

#### ▶ *Membership Numbers:*

- ▶ Depending on your angel group's goals and purpose, you may wish to limit the number of members. For instance, if the model that most ideally fits your interests and those of your members is to establish an angel investment fund with up-front fund commitment, you will want to set a defined size for the fund and a minimum investment per angel investor to give potential investors/members an understanding of the intended fund size.
- ▶ On the other hand, informal angel groups often limit membership to maintain a certain culture or to assure the continued cohesiveness of the group.

STATISTICS: *Number of members by organizational structure — Looking at the statistics from the 2003 CVR survey, we see various legal or organizational structures with the following membership numbers:*

- ▶ *Informal Affiliations: Typically not more than 20*
- ▶ *Non-profits: Groups range from 25 to 125 in members*
- ▶ *LLCs (typically funds): Many of the funds cap membership at 50 or 75*

▶ *Membership by Invitation Only:*

- ▶ Formal groups usually have a membership committee, with responsibility for member recruitment and selection and for ongoing member relations. Most groups appear to require a current member's recommendation or sponsorship for a new, potential member. With few exceptions, angel groups require members to complete a membership application, which typically contains a statement regarding accredited-investor status and recognition of the organization's code of conduct/ethics. Most groups require annual renewal of membership, with the reaffirmation of accredited-investor status and a pledge to group philosophy and conduct requirements.

- ▶ Be sure that membership-recruitment objectives and requirements are clearly communicated to all prospective members. Member applications should be reviewed, and new members should receive introductory materials clearly stating the group's organizational philosophy, goals, objectives, rules of conduct, and code of ethics.

▶ *Membership Tiers:*

- ▶ Individual members are a given, but some groups offer other tiers of membership. Affiliate membership may be offered to venture capital fund representatives. The VC fund could have a range of member rights, from attendance at meetings only to full participation rights in any deal. Whether or not a VC fund or sponsor is a voting member of your angel group is an individual choice; just be careful that, if voting rights are given, control is not inadvertently shifted away from the angel members. The advantage of including VC funds at some level of membership is the reciprocal value of sharing deals. This same point can create a disadvantage for some, with the fear that the VC will scoop the good deals out from under the group. These concerns can be alleviated to some extent by requiring VC funds to share deals in order to be members. Similar to VCs are investment bankers and broker-dealers, although angel groups must be more careful with their accredited-investor status. The same criteria should be used for these entities, with the additional requirement of no meeting solicitation (see discussion below on sponsorship).

► Depending on group financial resources, sponsor memberships may be attractive. The next section of this Guidebook will discuss costs and the options for coverage, but for purposes of the discussion, assume that you have decided to have some costs covered by outside entities. Professional service organizations, such as law and accounting firms, will fund angel organizations or events related to early-stage companies, wealth management, and other areas of their market focus. If an entity agrees to sponsor an organization or event, fairness and good business dictate that some benefit should be provided for the pledge, although group membership is not typically a benefit. The rub is how to provide these benefits without your group meetings turning into a networking event for service providers rather than focusing on deal screening and investment analysis. Some mechanisms to assure meeting focus include limiting the number of sponsors and sponsor representatives at each meeting and controlling any and all membership lists and correspondence. Benefits that may be provided to attract sponsors include introduction of guest speakers, opportunity to conduct member training sessions, sponsorship of the angel group's Web site, and placement of marketing materials and spiffs at meetings.

► *Dues and/or Investment Pledge:*

The expenses of running an angel organization must be covered somehow (see the list of possible costs below). Expecting members to continually donate materials, cover mailing expenses, or volunteer administrative and other support services is unrealistic, unprofessional, and short lived. Members should expect to pay dues to cover costs. The discussion in the **Group Operations** section, which begins on page 40, as well as Appendix 5, provides a sample budget calculation for estimation of costs. Also discussed in **Group Operations** are various sources of funding, including a percentage of pledged funds to cover management and operational costs for angel funds.

► *Desired Culture:*

Groups often limit membership, if for no other reason than to maintain a desired culture. Intimacy and frankness of discussion may be overriding goals that naturally limit the number of members. On the other hand, many groups find advantages in large numbers because of the resources available through better potential deal flow, the opportunity to make larger deals, and a greater pool of resources in membership skills and background.

Never underestimate the value of defining your culture. People are attracted to a group not only because of tangible member benefits, but also because of group goals and objectives, existing members, group reputation, and group dynamics. A well-understood membership-selection process helps to maintain the group's desired culture and a commitment to the desired group personality.

### **Membership Questions:**

The following questions may help you better articulate your membership structure and membership qualifications.

*Q. Will the group have a particular investment focus, such as software, telecommunications, biotech, or consumer products? Will you seek members with specific backgrounds or expertise?*

- ▶ If yes, your membership process should include a clear definition of group investment focus, and your membership recruitment should focus on individuals with experience in the relevant industry and interest in such investment directive.

You may wish to double-check your community assessment to ensure that your community has adequate interest and entrepreneurial base for a focused group; otherwise, you will need to consider a broader geographic investment range.

*Q. What will be the criteria for membership, other than the requirement that members be accredited investors?*

- ▶ Other membership requirements could be:
  - ▶ Particular expertise, such as marketing or finance
  - ▶ Specific background in an industry or market
  - ▶ Geographic
  - ▶ High net worth
  - ▶ Gender
  - ▶ Investment commitment
  - ▶ Previous investment experience
  - ▶ Time commitment

*Q. Should there be different tiers of members (e.g., individuals, VCs, sponsors)?*

- ▶ If yes, consider:
  - ▶ Different membership fees for VCs and other entities, usually higher than individual fees
  - ▶ Different fee for members outside your regional area (if accepting such members) and providing for their attendance at some percentage of total annual meetings (with corresponding reduction in fee)
  - ▶ Sponsors are generally not provided membership but rather allowed attendance at meetings for a defined number of representatives
  - ▶ Membership-fee amount depends on costs and other sources of revenue, as well as membership-fee tolerance

Q. *Will there be a limitation on membership numbers? Keep in mind that the larger the group, the greater the associated expenses in terms of communications, need for formality of operations and structure, meeting logistics, etc.*

- ▶ Will your angel group be a fund?
  - ▶ If so, your membership will be capped by the fund amount
- ▶ Do you desire a small, intimate group without any formal structure?
  - ▶ If so, your group should be no more than 15 members (as a guide) to prevent the necessity of legal formalities and administrative support that comes with larger groups
  - ▶ If not, your size depends on your ultimate group mission and goals (notwithstanding fund member limitations)

Q. *What will be the cultural atmosphere of your group? What are your priorities?*

- ▶ Everyone desires some cultural identification for their group. The group champion and founding board should spend time discussing and articulating values

▶ Some cultural attributes to consider are:

- ▶ Intimacy
- ▶ Learning environment
- ▶ Social
- ▶ Networking
- ▶ Experience sharing
- ▶ Pure investment
- ▶ Safe environment

▶ Setting cultural aspirations can be easy but preserving more difficult. This can be accomplished through:

- ▶ Clear articulation of culture in membership documents and on group Web site
- ▶ Regular reminder to members
- ▶ Consideration of desired culture when considering other types of membership such as sponsors or VCs
- ▶ Design meeting agenda to meet cultural goals
- ▶ Membership limitation may also be important

Q. *Are members willing to invest considerable time in group governance, management, and operations?*

- ▶ If no, be sure you have considered a manager-led structure
- ▶ If yes, and depending on the extent of member willingness to volunteer, a member-led structure can be quite effective with administrative support and/or an executive director

STATISTICS: *Membership numbers from the 2003 CVR survey show:*

- ▶ *No limit on membership: 66%*
- ▶ *Average size: 50 members*
- ▶ *Of those limiting membership:*
  - ▶ *53% are LLCs (which are limited if fund)*
  - ▶ *20% are informal affiliations (which limit for desired cultural or administrative reasons)*
  - ▶ *13% are non-profits*
  - ▶ *13% are corporations*

### **FINANCIAL RESOURCES: FUNDING YOUR ANGEL ORGANIZATION**

As with many organizations, funding an angel group adequately can be challenging at best. Asking members for group financial support through dues, a percentage of committed capital, a percentage of the carry, or a combination of these sources is a necessary evil. Rightfully so, members expect value in return, in the form of well-organized meetings, good deal flow, and a satisfying focus on investing.

STATISTICS: *Looking again at the results of the 2003 CVR angel organization survey, we find in response to a question on cost coverage:*

- ▶ *67% identified membership dues as one of the primary sources of group funding. Of these groups, 57% identified other sources of funding, including percentage of committed capital (mostly LLCs) and events or sponsorships (mostly nonprofits).*
- ▶ *31% listed percentage of committed capital as a source of funding. All but one of these were LLCs, which is logical, since the LLC legal structure predominates angel investment funds.*
- ▶ *33% identified sponsorships, with only two organizations listing this as their sole source of financial support.*
- ▶ *20% listed events as a source of financing, but none listed events as their sole source. The majority (63%) of organizations listing sponsors and/or events as sources of financing were nonprofit or 501(c) organizations (groups listing both sources were counted only once).*
- ▶ *28% indicated that costs were nominal.*

So what are the **attributes or parameters** of these various funding sources?

► **Membership dues:** If membership dues will be your sole source of funding, they must be set at an amount sufficient to cover all contingent costs and allow for a modest reserve. Annual membership renewal and dues payments will help with budgeting. Also, rather than having rolling renewal dates for members, choose a fiscal-year structure and have annual renewals some time before the start of your next fiscal year. For members joining mid-year, you can offer a percentage discount on dues to encourage membership.

The “Angel Equity Survey” created and managed by EMME Consulting found, in its Q1 2003 Preliminary Results, a significant variation in membership fees which may be explained by the disparity of services offered by angel groups. This variety of services included:

- Facilitation (meeting space and administration)
- Meeting meals
- Proposal funneling
- Introduction (introducing entrepreneurs to investors)
- Proposal screening
- Due diligence research
- Standard term sheets
- Legal services
- Investment/valuation analysis

► **Percentage of committed capital or pooled funds:**

- Angel funds in which members are required to commit capital up front typically have a portion of the committed capital allocated to cover operational costs. Along with the 2% to 3% to cover management costs, staff can be compensated and incentivized to maximize investment value and return by directing a percentage of the deal (referred to as the “carry”) to them. Often staff members are not accredited investors, which can pose a potential problem if the carry is given directly to staff. The discussion under Legal Structure, on limited partnerships, offers one structural alternative to resolve this problem. Your lawyer can recommend other solutions, including a possible LLC.
- Another form of “percentage of committed capital” is to allocate a portion of the group’s specific investment commitment to cover operational costs related to investments. This can be a bit complicated, but arguably fairly allocates expenses. The mechanics would be that after individual members make their contribution to the group investment, but before the actual investment is made, a percentage of the investment amount is carved out to cover the related costs. Problems that can arise from this approach that must be considered include:
  - The possible need for a separate legal entity for each investment, since members will be different for each investment (although some groups already successfully use this model, which will be further discussed under Investment Process).



- ▶ No one invests after expenses are incurred, and they must be covered.
- ▶ Disagreement as to the value and time contributed by staff and, even possibly, other members. This issue is arising with more frequency as member-led groups struggle with how to encourage members to volunteer for the time-consuming task of due diligence. A possible solution is to offer these members some form of compensation. Since cash compensation is usually not appropriate, offering a percentage of the group investment or warrants (if the company is amenable) may be a good solution, but this takes advance planning and group agreement.
- ▶ **Sponsorships:** Sponsors can be an effective and significant source of funding, as long as the group ensures that member meetings maintain their focus on member needs. It is important to control the number of sponsors and representatives. The **Group Operations** section contains suggestions for sponsorship parameters and benefits. Remember, however, that service providers will not generally sponsor an angel organization or any other group/event just to be good citizens. Budgets are often tight, and sponsors need to have some return on their investment for sponsorship dollars.

One caveat: many professionals are also accredited investors and would qualify for membership. An individual's professional background should not prevent membership; otherwise, your membership numbers may be limited. However, all members should understand that meetings are for evaluating investment opportunities and not for selling

services. Some groups have gone to the extent to include in their rules of conduct a prohibition against members actively soliciting other members during meetings.

- ▶ **Events and programs.** Investment and educational forums can be an effective mechanism for introducing promising new companies and educating the public. Any event is complex and time consuming and should be approached with this recognition. These events are well suited to nonprofit/tax-exempt organizations. For instance, fulfillment of a tax-exempt purpose of education can be met through a variety of vehicles, including a public educational program. Some nonprofit organizations use investment forums as a source of group funding, which can work particularly well in a community with unmet needs for matching investors and entrepreneurs or in which the angel organization has a strong presence to attract investors, presenting companies, and sponsors.
- ▶ **Company Fees:** Many organizations charge selected companies for the right to present at a member meeting. Most are willing to pay a reasonable amount for the privilege of exposure to a group of potential investors. However, the amount should not be so large as to drive good companies away or raise possible issues of broker-dealer status for the angel group. Some groups also charge a small amount to all applicants. This amount helps cover the administrative activities associated with processing the application. A slightly higher amount might be supportable for circumstances in which all applications are made available to members through the group Web site, thus increasing company exposure even if not selected for presentation.

## SUMMARY OF BUILDING THE FRAMEWORK

We hope that this first part of the Guidebook has given you considerable food for thought and valuable guidance in the establishment of your own angel organization.

Although not mentioned before because it seems obvious to the author, do not forget the most important reason for devoting thousands of volunteer hours to creating an angel organization — the journey and resulting successful group are rewarding, personally satisfying, and fun.

As a summary of key points in Building the Framework, the following table offers an alternative view of various choices in the decision process:

**TABLE 9:**  
Creating Your Angel Group Summary

ORGANIZATION TYPE	ORGANIZATION STRUCTURE OPTIONS	GROUP DYNAMICS	ADMINISTRATIVE AND OTHER SUPPORT	MEMBERSHIP REQUIREMENTS
<b>Member-Led Groups</b>	<ol style="list-style-type: none"> <li>1. Informal organization with little structure: Group of individuals loosely associated under no specific legal structure.</li> <li>2. Nonprofit corporation/501(c): Members operate under a more traditional corporate structure with a board and officers.</li> <li>3. Limited liability corporation (LLC): Gives similar advantages and governance options as a traditional corporation, with partnership form of member taxation.</li> <li>4. Corporation: Traditional structure</li> <li>5. Limited (liability) partnership: Often related to VC funds</li> </ol>	<p>Generally a volunteer organization, with members actively participating on various committees, which can include screening, education, public relations, sponsorship, membership, finance, due diligence, and the board or other governing body, if appropriate. The members are responsible for organizational activities and oversight.</p> <p>Many groups will hire an Executive Director and/or administrative assistant to support the members in functional duties such as meeting coordination, member communication, etc.</p>	<p>Administrative support generally is needed to coordinate multiple logistical activities, including membership lists and mailings, Web site, minutes of committee meetings, membership meetings, coordination of sponsors, recruitment, PR, etc.</p> <p>Sponsorship may also be necessary in order to generate sufficient funds to pay salaries for administrative staff and cover cost of materials, mailings, educational programs, etc.</p>	<p>Sources of financial support will dictate membership dues and the scope of meetings, events, and administration. If the organization chooses to avoid sponsorships but recognizes the need for administrative support, membership dues must be budgeted to cover all anticipated costs, plus a cushion.</p> <p>Members typically make their own investment decision, but some organizations have annual investment minimums or form separate investment vehicles, such as LLCs, for pooled investments.</p>

ORGANIZATION TYPE	ORGANIZATION STRUCTURE OPTIONS	GROUP DYNAMICS	ADMINISTRATIVE AND OTHER SUPPORT	MEMBERSHIP REQUIREMENTS
<b>Manager-Led Groups</b>	<ol style="list-style-type: none"> <li>1. Limited liability corporation</li> <li>2. Corporation</li> <li>3. Nonprofit/501(c) organization</li> <li>4. Limited (liability) partnership</li> </ol> <p>All of these types of organizations can have a formalized structure, with management responsible for numerous activities, including screening and evaluating prospective deals, group investments, member communications, etc.</p> <p>The LLC structure is often associated with an angel fund.</p>	<p>Members are involved at various levels depending on their interests, market or industry expertise, and general desire.</p> <p>Members often assist the manager or can lead functional efforts in strategic planning, member relations, or investment identification and selection.</p>	<p>Staff includes a full- or part-time manager, often along with administrative support. An MBA student may also be a member of the staff, often interning through a local MBA program.</p> <p>The manager can often receive part of his or her compensation through a carried interest (the “carry”), thus giving the manager a greater stake in the investment process.</p> <p>Members are assessed an annual fee to cover the manager and administrative costs. The manager and administrative staff can also be compensated through a small percentage of the committed capital (2% –3%), along with a possible carry.</p> <p>Other sources of group financing such as sponsorships can help cover manager costs.</p>	<p>In many manager-led groups, members have capital commitments, with the total amount generally due at two or three closings, depending on the intended length of time for investment. Investing can also be by individual member choice. These organizations sometimes have side funds, which make bridge or complementary investments with members.</p> <p>Investments can be through the angel organization or through separate, deal-specific legal structures such as LLCs.</p> <p>With angel funds, members can usually invest additional amounts on an individual basis into companies the organization chooses to invest in and may also invest outside the organization as an independent investor in non-selected companies.</p>

## GROUP OPERATIONS (IMPLEMENTING YOUR ANGEL GROUP)

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You have now decided on the structure for your angel organization, including:

- ▶ member versus manager led;
- ▶ legal structure;
- ▶ investment process;
- ▶ membership; and
- ▶ financial resources.

In many respects, these decisions are the easy part, as the actual operation of an angel group can pose the most difficult issues. Proper and thoughtful implementation of your plan will determine the future of your group, member satisfaction, investment success, fulfillment of your group's objective, and group culture.

### MEMBERSHIP

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Under the **Building the Framework** section of this Guidebook, you went through various questions and exercises to determine who should be a member. Properly identifying and communicating with those potential members is equally important. As many will testify, good communication is the key to any successful relationship, and an angel organization and its members are no exception. Early and complete communications through written materials and/or Web site will minimize misaligned expectations.

### RECRUITMENT, SCREENING, SELECTION, AND ORIENTATION:

Your selection process must reflect all desired member attributes, from possible skills and background to investment beliefs. To align member selection with group goals and investment structure, you should have:

- ▶ Written materials and/or a Web site clearly and accurately describing membership qualifications and requirements. (See Appendix 1 for sample Membership Information Document.)
- ▶ Written materials and/or a Web site describing your organizational structure, possible investment expectations, and group philosophy. A code of conduct for members, which includes the respect of other members' privacy and the confidential nature of information received at meetings, is always a good idea.
- ▶ Member recruitment and selection committee members who understand your group and who can effectively communicate, being group spokespersons and ambassadors.
- ▶ Committee members who are willing to thoughtfully review applications, interview candidates, and host prospective members at a group meeting. Committee members should ideally be well connected in the community.

- ▶ A membership application with qualifications, group philosophy, code of conduct and ethics, and reasons for removal stated on the application. (See Appendix 2 for a Membership Agreement.)
- ▶ A stated mechanism and well-understood reasons for termination of membership.
- ▶ An annual renewal and application review process that includes member affirmation of accredited-investor status. (See Appendix 3 for Annual Membership Profile.)
- ▶ A written process reflecting all these steps.

Potential members should be allowed the opportunity to experience a group meeting to gain comfort with the group's meeting and investment process. Such a visit allows the guest and the group to evaluate fit and mutual interests. Guests can be handled in a number of ways. One effective mechanism is to offer complimentary attendance at a meeting, including the meal, or charge the guest a nominal amount. However, you should limit the number of "free lunches" and require a decision on membership after a potential member attends a meeting. People requesting additional meeting attendance before making their membership decision should be asked to pay an amount equal to annual membership dues divided by the number of meetings per year.

## **BACKGROUND/EDUCATIONAL NEEDS:**

Another important aspect of membership recruitment is alignment of members' expertise with group investment focus and needs. Additionally, even with identified member selection criteria and needs, education is a vital component of any angel group.

### **▶ Members' background and experience in**

**investing:** Many angel organizations choose an investment focus, such as software or life sciences. Such a focus may drive membership requirements or preferences but can also be a self-selecting attribute. In other words, prospective members without any experience in the area of a particular group's focus may not consider membership for lack of interest or investment alignment. As will be discussed more under deal screening and due diligence, logic dictates that successful angel organizations will have members who are experienced in various aspects of the group's market focus (if your group chooses to have a focus). They will also have members knowledgeable regarding the various attributes of a successful business, such as marketing, financing, information systems, research, operations, manufacturing, human resources, and senior management. By definition, angel organizations are made up of active investors, so, typically, members rely on one another's expertise and objective analysis of potential investments to evaluate companies.

Therefore, in membership recruitment, your group should seek out potential members who complement the skills and experiences of existing members to give the group a solid core of knowledge.

- **Education programs:** Not all members join angel groups with previous angel investing experience, and very few angels have adequate depth of knowledge in all facets of investing. Part of the concept of an angel organization is to cultivate new, active angel investors and to further educate members. Hands-on learning through just doing deals and informal mentoring by experienced members are valuable learning mechanisms. However, the fear is that critical and basic aspects of angel investing are missed in this semi-disjointed education.

One should strongly consider periodic intensive training for new members, including training on the basics of company assessment that covers many topics, from financial and market analysis to management. Such training can be done by the angel organization itself or through third-party education programs. Many angel groups also invite guest speakers to regular meetings to discuss relevant topics such as market trends and investment terms. As previously mentioned, such training and other speaking opportunities can provide value to sponsors. (See Appendix 4 for a list of typical topics covered in angel investor education.)

## **TIME COMMITMENTS:**

Member willingness to volunteer time is an important factor in determining whether your group should be manager or member led. Cost is also an important factor. The following list gives you an idea of the various duties and responsibilities in an angel group. Of course, an informal affiliation would not require all of these functions, but this structure also limits the size and intent of the group.

**TABLE 10**  
Organizational Activities and Duties

ACTIVITIES	POSSIBLE RESPONSIBLE PARTY
<b>Governance:</b> <ul style="list-style-type: none"> <li>▸ Strategic direction/philosophy/goals</li> <li>▸ Development of operating documents</li> <li>▸ Development of operating plan</li> </ul>	Members/board of directors (or equivalent), with support from manager or executive director.
<b>Operations:</b> <ul style="list-style-type: none"> <li>▸ Member communications</li> <li>▸ Web site development and maintenance</li> <li>▸ Meeting coordination</li> <li>▸ Training</li> <li>▸ Speakers</li> <li>▸ Finances, including dues and sponsors</li> <li>▸ Events</li> <li>▸ Group management</li> </ul>	<p>Board committee, manager and/or executive director, with support from administrative staff.</p> <p>Executive director or administrative staff with member oversight. A manager can handle all of these duties as well, although fiduciary duty dictates that members must have financial oversight or ultimate responsibility.</p> <p>Members can handle any or all of these duties on a volunteer basis. If you choose this structure, be cognizant of volunteer “burn-out,” consistency of structure and application from one group of volunteers to another, and loss of momentum.</p>
<b>Membership:</b> <ul style="list-style-type: none"> <li>▸ Recruitment</li> <li>▸ Screening</li> <li>▸ Relations</li> </ul>	The membership committee is an important attribute of any angel group. Executive and administrative staff can have varying degrees of responsibility, but members should have an active role in member relations.
<b>Deal sourcing</b> (Potential sources of deals include members, professional service providers, entrepreneurial support groups, investment forums, and venture capitalists, along with your group Web site.)	Members are the best source of deal flow and, as such, need to actively seek out potential companies. The group manager and/or administrative staff can handle the coordination of these activities.
<b>Deal screening</b> (By definition, angels are active investors, and one of the important steps in the investment process is deal screening.)	A selection committee made up of a subset of the members can do initial screening to select presenting companies.
<b>Entrepreneur communication</b> (Active and constructive communication with applicant companies, as well as with those chosen, improves the public image of your group and attracts good deals.)	Managers often handle company communications, as can executive directors. Administrative staff can also coordinate the correspondence, with member oversight of content.
<b>Presentation coaching</b> (Every selected company needs coaching before presenting at a group meeting. Your group may have specific information needs, and companies should be coached to include this information. Companies also need coaching on how to effectively communicate the essential aspects of their business in a short time period.)	As with deal screening, member involvement in coaching is important. Some manager-led groups allow the manager to do most of the coaching, but for member-led organizations and at early stages of a group’s maturation, members should take an active role in company coaching to better understand the investment process.

ACTIVITIES	POSSIBLE RESPONSIBLE PARTY
<b>Due diligence:</b> <ul style="list-style-type: none"> <li>▸ Coordination</li> <li>▸ Actual analysis</li> </ul>	<p>Members should be involved in the due diligence process. Administrative staff can carry out coordination, and a manager can facilitate and support much of the actual analysis. However, to make intelligent, informed investment decisions, members must take an active role in due diligence.</p>
<b>Investment:</b> <ul style="list-style-type: none"> <li>▸ Negotiations</li> <li>▸ Coordination</li> </ul> <p>(In most organizations (70%), individual members make their own investment decision. Even with individual decision-making, group due diligence still has tremendous value and is one of the fundamental reasons for establishing an angel group.)</p>	<p>Seasoned management can negotiate the actual investment, with member involvement to ensure agreement with the terms and to gain experience. Depending on group structure, the manager or executive director may be appropriate for coordinating the actual investment.</p>
<b>Investment follow-on</b> (Once the investment is made, either through the group or individually, staying abreast of company progress and adding value as appropriate are essential.)	<p>Managers are valuable for follow-on communications and updates, as can be executive directors. With member-led groups, a lead investor often is chosen to maintain the ongoing relationship with the invested company and keep the other members informed. If the group investment is significant, a board position may be negotiated, and the lead investor or a designated group member, if invested as a group, may take the board seat.</p>
<b>Promotion/public relations</b> (The first reaction to this category is why does an angel group have to worry about promotion? However, a group will have little or inappropriate deal flow unless there is public familiarity with the group's existence and investment focus. Web sites, community involvement in regional investment forums, and promotion of a positive public image are critically important to the success of an angel group.)	<p>All members of an angel group should be considered group ambassadors. A board committee, manager, or the executive director can coordinate activities. The Web site can serve as the primary window into your group, with the content well thought out and kept current.</p>



## MEETING STRUCTURE

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Surprisingly, meeting time, format, and content can often be the most difficult points of agreement for members. For anyone who has scheduled meetings or put on events, everyone has different schedules, different interests, and individual circadian rhythms. Here are some parameters to consider:

### TIMING AND LOCATION:

- ▶ How often? Monthly or semi-monthly? Summer and/or holiday hiatus?
- ▶ Time of day? Meal included?
- ▶ Meeting location for convenience of members? Same or rotational locations? Parking issues? Need for privacy?

### FORMAT:

- ▶ Length of meeting?
- ▶ Networking time desired? With or without presenting companies present?
- ▶ How will group business be handled?
- ▶ Where in the meeting schedule are company presentations? Will you require a PowerPoint or other presentation materials from companies?
- ▶ Do you desire a “members-only” session after company presentations? Does your location accommodate such an arrangement?

- ▶ What preparation is needed for meetings? How will you handle meeting announcements and RSVPs? What kind of information should be provided? Who will coordinate logistics?
- ▶ How far ahead of meetings should the screening committee meet to select the presenting companies? Do you plan to coach the presenting companies, and, if so, how much time is needed before the meeting?
- ▶ What are the manager/executive director/administrative staff responsibilities?
- ▶ What is the timing of board or committee meetings in relation to regular member meetings?
- ▶ Who is responsible for the Web site? What information should be included? Should there be a members-only section? Do you wish to post all company applications for member access?

### EDUCATION:

- ▶ Do you want regular educational sessions as part of member meetings?
- ▶ If so, would you like guest speakers? Can management handle speaker coordination, or should there be a member committee on education?
- ▶ Do your members need intensive, initial training on angel investing? Should other members, local professional service providers, or third-party programs conduct the training?

And the list goes on. As we all know, better up-front planning makes for well-executed meetings and happy members. Planning also impresses presenting companies, which drives deal flow.

## GROUP BUDGET

Earlier in the Guidebook, we talked about various sources of financial support for your angel group; now, to give you a start on operational costs, the following table lists possible expense items and a rough cost range. These costs have a fair deviation and are influenced by multiple factors, including group structure and regional fee rates. Therefore, these costs should be considered a gross guide only.

**TABLE 11**  
Group Expenses

EXPENSES*	RANGE
<b>Management:</b> <ul style="list-style-type: none"> <li>▸ Manager</li> <li>▸ Executive Director</li> <li>▸ Administrative support (and benefits)</li> </ul> <p>You can also use percentage of carry as part of compensation if the organization is structured to accommodate such form of compensation. Some groups also share administrative support with other organizations, decreasing this cost and better aligning need with expense.</p>	<ul style="list-style-type: none"> <li>▸ \$70,000 to \$150,000</li> <li>▸ \$50,000 to \$80,000</li> <li>▸ \$25,00 to \$45,000</li> </ul> <p>Some groups have MBA students working for a nominal amount and/or earned credits through an approved program.</p> <p>Along with geographic factors, responsibilities and duties influence the cost of management.</p>
<b>Web site development and maintenance</b>	\$3,000 to \$20,000 for development; \$2,000 to \$6,000 for annual maintenance. This is an area in which you may be able to identify an in-kind sponsor if compatible with group interests.
<b>Meetings:</b> <ul style="list-style-type: none"> <li>▸ Member (including a meal–lunch for this analysis)</li> <li>▸ Board (including a meal)</li> <li>▸ Committees (not including a meal)</li> </ul>	\$25 to \$45 per attendee, depending on meeting location, room charges, beverage coverage, guests, etc. Sponsors may wish to offer their facilities for board and committee meetings, which will lower your overall budget.

EXPENSES*	RANGE
<b>Member relations and communications/correspondence:</b> <ul style="list-style-type: none"> <li>▸ Meeting announcements</li> <li>▸ Program announcements</li> <li>▸ Letterhead</li> <li>▸ Annual surveys</li> <li>▸ Membership information packet and gifts (mugs, portfolios, etc.)</li> <li>▸ Newsletters</li> <li>▸ Important events or occurrences</li> </ul>	<p>\$7,500 to \$75,000. Many groups are trending toward e-mail as the only mechanism for member communication, either in coordination with the group Web site or not. Surveys can also be conducted online, and many people actually prefer this format. Other groups prefer the look and image of mailed invitations and announcements. Events and large programs are better suited to traditional mailings. Events and programs often have specific sponsorships, which can cover these costs.</p>
<b>Public relations:</b> <ul style="list-style-type: none"> <li>▸ Logo and image development</li> <li>▸ Promotions plan</li> </ul>	<p>\$5,000 to \$50,000. As with so many other cost estimates, the range is broad, depending on whether you want just a logo or desire a substantive promotions plan. In-kind sponsorship may be possible for this particular category, including member gifts noted above.</p>
<b>Office expenses:</b> If you have dedicated staff and need to provide office space. Also included are operational costs related to most organizations, such as postage, banking services, and insurance. <ul style="list-style-type: none"> <li>▸ Office rent</li> <li>▸ Office furniture</li> <li>▸ Office equipment</li> <li>▸ Utilities</li> <li>▸ Postage, courier</li> <li>▸ Professional fees</li> <li>▸ Insurance (D &amp; O and general comprehensive)</li> <li>▸ Banking services</li> </ul>	<p>\$15,000 to \$200,000. Your group may be able to share space with another organization or sublet space from a sponsor to minimize costs. Office expenses can be lower if entirely member led, with no management or other administrative staff, which would limit costs to only a few items.</p>
<b>Programs/events:</b> <ul style="list-style-type: none"> <li>▸ Member training</li> <li>▸ Investment forums</li> <li>▸ Public educational programs</li> </ul>	<p>For most groups, special events and programs, even for member training, should be covered by the revenue sources for those events.</p>

The “Angel Equity Survey” created and managed by EMME Consulting showed in its Q1 2003 Preliminary Results that annual administrative costs varied significantly, with a range of \$300 to \$300,000, with an average annual administrative cost per investor of \$1,054 (median \$1,000). The administrative costs per investment opportunity averaged \$6,700 (median \$1,230) per business proposal “viewed” and \$16,441 (median \$10,000) per proposal “seriously considered.”

\* All expenses are based on FTE annual salary for management and annual cost basis. Venture capital funds provide a good comparison for manager-led organizations. (Appendix 5 is a revenue and expenses worksheet for your use in developing a budget.)

## SPONSORSHIPS

As discussed under the **Building the Framework** section, sponsorships can be an effective and viable mechanism for funding (at least partially) your angel group expenses. Many groups shy away from sponsorships because of the fear that meetings will become a vendor event rather than staying true to angel investing. There are steps that can be taken to prevent or minimize sponsors monopolizing the meetings. At the same time, one must remember that sponsorship is not provided out of charity, but rather sponsors represent legitimate and important business services and need recognized benefits for their dollars.

### CONTROL OF SPONSORSHIP ACTIVITIES:

- **Limit the number of sponsors.** If you have a tiered sponsorship structure, you may want to offer exclusivity for particular professional categories (e.g., accounting, law, investment banking) for the highest sponsorship level. The overall number of sponsors should remain at a level such that representatives will still be a minority of meeting attendees.
- **Limit the number of sponsor representatives.** Even for large, top-tier sponsors, meeting attendance must be limited to two or three representatives. A rule of thumb is a ratio of six members to one sponsor representative at a meeting (a total for all sponsors).

- **Clearly articulate the rules of attendance for sponsors.** Let a sponsor know that their presence is to be low key. Allow sponsors to place marketing materials at a designated location in the room, but not set up booths. Spiffs or give-aways are often fun or useful, so allow sponsors to place items by their materials or on dining tables, but with quantity and frequency controls.
- **Ensure that sponsors** understand and value your group philosophy, goals, and objectives. The better everyone understands each other, the greater opportunity there will be for a successful relationship. Be honest and up front about limitations and requirements.

### SPONSORSHIP BENEFITS:

- **Interaction with members at meetings.** Sponsors are unlikely to sign up unless they understand the opportunity to interact with group members. But, as discussed above, the number of representatives should be limited.
- **Exclusivity for top-tier sponsorship.** If you create a tiered sponsorship structure, you can often give the top-tier sponsors exclusivity in their professional category (e.g., one law firm, one accounting firm). This gives a sponsor the comfort of having no competition in their professional field.

► **Marketing materials and promotional materials.**

As discussed above, allow sponsors to place marketing materials at a designated location, but shy away from booths, which can dominate a meeting. Items such as pens and stress balls can be placed by marketing materials or on dining tables. Passive use of materials satisfies sponsorship needs for take-away reminders but allows members the choice of taking or not taking the materials.

► **Training/speakers/event coordination.**

Sponsors can play a valuable role in coordination of group training, guest speakers, and events. Not surprisingly, sponsors are attracted to groups and events that complement their area of professional expertise. Coordinating and conducting member education and training can be a very effective way for sponsors to showcase their skills. Sponsors often have good connections to relevant speakers and would enjoy introducing speakers at member meetings. Events such as investment forums also fit well with sponsor interests.

► **Web site and program recognition.** An easy benefit to offer is prominent display of sponsor logos on the group Web site, in meeting programs, and even on group letterhead. This also allows for recognition of sponsorship level, if you decide to offer tiered sponsorships.

► **Company coaching.** Sponsor representatives may be very effective coaches for company presentations. This also allows sponsors the opportunity to interact with promising new businesses and possible new clients. Coaching often needs a set location, which particular sponsors can provide.

► **Mailings.** Be very careful about sharing member lists. Nothing drives a member away faster than receiving copious amounts of unsolicited mail. Be sure to control all member correspondence. Give sponsors the opportunity to post useful information on the Web site, such as due diligence tips and invitations to sponsor events of possible interest to members.

► **Table sponsorship.** Periodically, you may wish to offer sponsors the chance to host a table at an event, at which time they can invite prospective, qualified members who may have some relationship to the sponsor. This gives the sponsor an opportunity to impress clients and to increase membership for your group.

## INVESTMENT EVALUATION AND PROCESS

The investment process can take many forms. These range from members making their own investment decisions to investment of group funds based on committee or manager recommendations. The actual investment structure can vary from individual investments to creation of a limited liability company for each investment to investments from an established fund. For purposes of this discussion, let's walk through the entire investment process, discussing alternatives for each step.

## DEAL SOURCING

The success of any angel organization is ultimately based on the quality of investment opportunities available for its members. Generally, members are the best source of business plans. If members are active investors in the community, they will usually have a known reputation and have their own deal sources. These sources include many of the following:

- ▶ **Service providers**, such as lawyers, accountants, and investment bankers, are good sources of deal flow. Many conduct their own analysis of early-stage companies before agreeing to accept them as clients. If sponsorship is one of your group funding sources, providing an opportunity for sponsors to submit clients for possible presentation can be a defined benefit.

- ▶ Another source of deal flow is **venture capital funds**. Venture funds often receive business plans from entrepreneurs too early-stage for VC investment needs and interests. Inviting regional venture capital funds to be associate members or establishing an ongoing relationship with these venture funds can provide an early look at companies for VCs and encourage them to send interesting business plans for your group's investment consideration. Additionally, VCs may offer the angel group limited opportunities to participate in first-round venture financings because of the positive aspects of this relationship.
- ▶ **Investment forums** and similar events can be a good source of presenting companies, as these businesses have generally already gone through some form of screening to qualify for presentation at the forum.
- ▶ Some groups have also found good potential deals through **local universities** that have a strong technology-transfer program and **enterprise centers**, which support development of entrepreneurial companies and community entrepreneurship.
- ▶ Direct application through a **group Web site** can generate possible investment companies, although most angel investors generally prefer a referral from a member or trusted service professional.

Even with companies sourced through members, professional service organizations, VCs, and other methods, the best angel groups use one uniform mechanism for company applications, typically the angel group Web site. This provides an opportunity to inform applicants of your rules of presentation as well as the screening and selection process, and to handle any charges associated with company applications. As such, groups should route all applications, regardless of source, through one channel, such as a Web site or e-mail address. (Appendix 6 shows a list of company information requests.)

### **DEAL SCREENING**

As with nearly any aspect of an angel organization, the screening process can vary from informal, with selection conducted by volunteer members, to a formal process in which the manager coordinates and conducts much of the screening. The screening process provides a mechanism for selecting companies that the entire angel group will review, typically through presentations at member meetings. Regardless of the level of formality, some type of screening process should be established to avoid taking up the members' limited time at periodic meetings with business plans not worthy of investment review and consideration. Individuals volunteering to review applications should be experienced in evaluation of early-stage companies. Depending on the number of applications, an organization may wish to consider a

tiered review approach, with initial selection of several companies for presentation to the screening committee. From these presentations, a smaller number (say two to four companies) can be selected to complete the coaching process and eventually to make presentations at a group meeting.

Some groups have MBA interns serve on the screening committee alongside members, often completing initial screening of all applications against a list of group criteria. Duties may also include interviewing the entrepreneur to obtain needed additional information as part of the evaluation process. The MBA students then create a report for the screening committee.

For purposes of maintaining uniformity and controlling the number of hours each screening committee member must commit, it is recommended that organizations accept only executive summaries from applicant companies. In addition, as mentioned above, it is best that all applications come through one avenue, whether that is the group Web site, the screening committee chair's e-mail, or the group manager's address. Screening should be done using a well-developed and uniform evaluation form or matrix. Such forms help to ensure that evaluations are thorough, fair, and objective. (See Appendix 7 for a sample Screening Worksheet.)

For groups with screening committees comprised of members, have a small group of experienced angel investors lead the screening process, with two or three apprentice members learning the ropes but not voting on company selection. Learning angel investing occurs in many forms, and this type of mentoring and hands-on education can be beneficial.

Some groups require presenting companies to have a member sponsor them, with at least one member agreeing to invest or having already invested in the company. Such requirement for a “guardian angel” has decreased in popularity with recent reductions in investment activity and the fact that this process does not necessarily guarantee better deal flow. Some groups do have a member assigned to a presenting company for purposes of shepherding or mentoring them through the coaching and presenting process. For manager-led groups, the manager often takes on this role.

## COACHING

As previously mentioned, quality deal flow is a critical factor for the success of any angel organization. Experienced angels want to see the best opportunities in town and entrepreneurial teams with good communication skills. Coaching the selected businesses can make a significant difference in ensuring that companies present the right information, in an effective format, using their best representatives. Some groups give presenting companies exact instructions on what to

include in their presentation and meeting handouts. Sponsors (such as law or accounting firms) are often keenly interested in providing these coaching services at no cost and, in fact, as a benefit of sponsorship. These service providers see the opportunity to coach presenters as a chance to promote their services and possibly obtain a new client that is already considered a cut above.

Most companies see coaching as a benefit, particularly if a group charges companies for applying and/or presenting. As with other steps in the investment process, the manager of a manager-led organization may take on the responsibility of coaching companies along with other aspects of deal screening and investment. The allocation of these various responsibilities will depend on member preferences, interest in participating in various steps of the process, legal structure, group collective experiences, and manager experience, as well as the level of organizational funding (i.e., more work by the manager and staff equals greater overhead costs).

## COMPANY PRESENTATIONS

Many groups have company presentations at regular group meetings. Typically, two to four companies present for a limited time frame (ten to fifteen minutes), followed by a short question-and-answer session (five to ten minutes). After the presentations, many groups ask the companies to step out of the room for group discussion of investment interest. This group-only discussion time serves a greater purpose



than just a determination of “go” or “no-go” for presenting companies. Members have the opportunity to share additional information they may possess about the market, product innovation, and management, and to develop an effective message to communicate to the entrepreneur, particularly if that business is not selected for continued funding consideration. These discussions also provide an excellent learning experience for new members.

Your actual group structure will dictate a variety of approaches to follow-up activities. For instance, if you are member led and members make their own investment decisions, you may have a process in which those members expressing an interest in continuing discussions with a presenting company form a due diligence committee to thoroughly evaluate the company. That group could then divide up the duties depending on expertise, with investments still being made on an individual basis. At the other end of the spectrum, if the group is an angel fund, the group may vote on whether to proceed with due diligence and members may be identified to support the diligence process based on their background and expertise, often led by a manager.

## **DUE DILIGENCE**

Due diligence can be the most complicated and time-consuming part of angel investing. Many publications have been devoted to the due diligence process. This discussion is limited to suggestions for structure,

rather than the steps and topics for due diligence. (Sample due diligence questions and a checklist are provided at Appendices 8 and 9, respectively.) In a manager-led organization, the manager will typically lead the investment-evaluation process. The manager will also often negotiate the structure of an investment or participate in the negotiation process with the lead investor. In member-led groups, whether an informal group with individual investment decisions or one in which members invest collectively, the due diligence process must ensure coverage of relevant topics and should be conducted by those with experience and expertise in particular areas. Some groups retain MBA students to support due diligence through an internship program with the local business school. Other groups retain outside experts to evaluate a company or give a briefing on cutting-edge technology related to the potential investment.

One angel group with a sidecar fund has the fund complete all due diligence on companies presented to the related angel group. Based on this due diligence, the fund members vote on whether or not to fund at the meeting. If the side fund decides to fund a company, it then shares the results of due diligence with interested members of the angel group to round out the investment offering.

## INVESTMENT VEHICLES

Needless to say, there are a variety of investment mechanisms and nearly countless number of investment terms. (See Appendix 10 for a glossary of private financing terms.) Angels invest locally for many reasons, including an interest in staying connected to the portfolio company, familiarity with the local market, and desire to give back to the community. A few exceptions are organizations with an investment focus that requires a broad geographic review of potential deals, such as sustainable technology, energy efficiency, environmentally friendly products, or companies with a social-venture aspect. Therefore, throughout the process, from deal sourcing to signing the investment check, local investments prevail.

## INVESTMENT TERMS AND NEGOTIATIONS

An essential part of the investment process is the form of investment. This Guidebook will not deal with the differences between debt and equity, common versus preferred stock, or the multitude of possible investment terms. See Appendices 11 and 12 for sample term sheets with investor-favorable and company-favorable terms and annotations, respectively. These term sheets are very comprehensive and more reflective of a venture capital fund financing, but do give an excellent evaluation and consideration of numerous terms and options. Angel investors, often being the first outside money in a company, need to be cognizant of follow-on

funding needs and the possible sources for this additional company capital. Do not make the terms so complicated or onerous to effectively prevent attracting follow-on financing, which is undesirable for the company and angel investor.

The purpose of this Guidebook is to relate these activities to various angel group structures rather than to discuss terms and negotiation techniques. Your angel investment training should include a fairly lengthy session on terms, which can seem complicated and hopelessly confusing to the new investor. Local professional service providers, such as lawyers and accountants, often have extensive hands-on experience with investment terms and negotiation techniques.

From an operational perspective, in manager-led groups, the manager often plays an integral and key role in determining and negotiating investment terms. A manager's (and, for that matter, a member's) ability to negotiate investment terms will depend on a few key factors:

- ▶ Is your group the lead investor? If not, you probably have little influence over the terms and must rely on the sophistication of the lead investor to negotiate investor-favorable terms. If a VC fund is leading the round, you will most likely receive favorable terms.
- ▶ Does your manager (or do your members) have the requisite experience? With the first few investments, and even thereafter as a safety factor, professional advice should be sought and used.

- Has the company already established terms, and does it have multiple potential sources of funding? Entrepreneurs usually know if they are a “hot” deal. If this is the case and you want to play, both your ability to get in on the deal and your negotiation leverage may be limited.

## LIABILITY AND RISK EXPOSURE

With any structure in which members make independent investment decisions, there should be a strong disclaimer of organizational liability. The disclaimer should indicate specifically that each member makes his or her own investment decision and that the organization is not recommending any particular company for investment. (See Appendix 2, Membership Agreement for sample disclaimer.) Members with a relationship to any company presenting (e.g., as a board member, advisor, officer, or current investor) should disclose to the group their relationship with the presenting company to ensure fair and equitable review of a potential investment. In theory, with greater organizational structure, you should provide insulation from liability for board members and others actively involved in organizational management. However, there are no risk-free circumstances, and you should consider obtaining insurance for directors and officers, as appropriate, depending on your legal structure.

## FOLLOW-ON RELATIONSHIPS AND ACTIVITIES

One of the reasons angel investors invest almost exclusively on a regional basis is the desire to stay close to their investments.

So what type of relationship should an angel investor expect from an investment? The answer will depend to a great extent on investment size, specifically the percentage of the round or the percentage of the company acquired by the angel investor or angel group. Taking the lead position in a funding round provides leverage to request a board seat or board-observation rights. Whether an angel investor, or representative of an angel fund or pooled investment, takes a board seat at all is another question entirely. The answer depends on fit with existing board members, skills needed on the board, investor recognition of the increased time commitment, and possible increased liability exposure as a director.<sup>11</sup>

Outside of the more active role of board director, all angel investors should insist on information rights, which include, at the very least, annual financial statements and annual report. Some investors ask for management visitation rights, and others request additional information, such as all business plans, quarterly financials, and annual operating plans. The amount and quality of information you receive will depend on your desired level of involvement and the company's willingness to share information with a minority investor.

<sup>11</sup> Recent regulations, particularly under the Sarbanes-Oxley Act, raise further concerns about director liability. One should consult counsel about possible liabilities before accepting a board position.

Some angel investors also become advisors or mentors to the company, serving on an advisory board or committee. Caution dictates that angel investors should not demand a paid advisory role as a quid pro quo for their investment. Such arrangements border on a fee-for-investment arrangement, which can create multiple securities law issues for you and the company. Advisory boards (as with board of directors) in early-stage companies may receive options for their services, with a vesting schedule correlating to the time of service.

Equally important in the follow-on relationship is the tracking of investments. Individuals and groups should have a list of information categories that are periodically analyzed. Groups should have a reporting system for sharing this information with the entire group. Organizations may even wish to periodically survey companies, members, and selected members of the public about group perceptions, company experiences, and member satisfaction. (See Appendix 13 for sample Public Survey.)

### **PROMOTIONS/PUBLIC RELATIONS**

This section is not intended to suggest that angel groups should take out glossy ads in local business publications, but rather as a recognition that, for many groups, community awareness or public familiarity is essential for quality deal flow and member recruitment. Most groups want to be known for their professional structure and processes, supportive environment, and positive culture.

The group's organizational structure will determine the need to actively recruit members. Small informal groups that are satisfied with their membership structure and numbers will not be interested in public relations from the context of additional members. But even for such groups, some level of public awareness is important, if just to ensure good deal flow. For groups interested in recruiting, membership benefits and obligations must be clearly articulated in written materials and/or on the group's Web site. This allows the membership committee to present a well-organized group with understood goals, objectives, and philosophy.

Public familiarity with an angel group helps with deal flow, often increasing quality deals and applications that relate to the group's investment goals. Angel groups may wish to host an investment forum or participate on various committees for investment or entrepreneurial programs. All these activities relate to image and public face. The more that is known of your group's active investment history, intelligent and thoughtful review of applications, and active involvement with portfolio companies, the more the group's reputation will be enhanced, and the more new members and good investments will be drawn to the group.

## SUMMARY OF GROUP OPERATIONS

This discussion of angel group operations may have left you wondering how to successfully pull everything together. The appendices should help you with many of the mechanical processes. Also, knowing that many other angel groups have started and continue to operate successfully should give you comfort that you are not alone. In a recent publication, Angel Healthcare Investors, LLC summarized the attributes of their group that relate to their continued success and sustainability. This table references many of the discussions and topics in this section of this Guidebook:

**TABLE 12**<sup>12</sup>  
AHI Tactics for Promoting Sustainability

PROCESSES	TRADITIONS	COMMUNICATIONS
New-member packet	Annual meeting	Investment memos
Deal-flow process	Summer meeting in Cape Cod	Angel Healthcare Web site
Subcommittee process	Member Spotlight	Meeting minutes
Investment process	Member breakfasts	Portfolio updates
Secure file sharing	Annual staff outing	Guest speakers
Monthly planning meeting	Henderson house meetings	AHI Box Score
Monthly member meetings	Member booklet	Secure member Web site

The most important reason for (and initially the single reason) forming your angel group is investing. The **Building the Framework** section of the Guidebook took you through the formation process, keeping in mind, at all steps, this investment purpose and allowing that investment vehicle to steer you in the right direction for structure, membership, etc. Similarly, the **Group Operations** part has covered the investment process once the group is operating. In summarizing the investment process from the operation's perspective, there are a few simple rules which will bode well for your group regardless of structure or process. Therefore, what are some of the **basic points of angel investing**?

- **Keep the terms simple** if follow-on funding, particularly from VCs, will be necessary. Nothing can prevent follow-on funding faster than an overly complicated and burdensome first round, which a VC must try to unwind, often demanding a discounted value and other "cram-down" requirements to offset onerous or overreaching first-round terms.
- **Reserve an investment amount** if you expect to support the next round of funding. With the evaporation of VC capital in early-stage financing, more and more angel groups must fund the second round of financing. One of the biggest concerns for angel investors is lack of follow-on funding. In addition, entrepreneurs often need more funds than they originally expected in order to meet the goals connected to the funding round in which the group participated. If this is an issue, one must plan for this possible need or work to help the company find the next round of funding; otherwise, you have just thrown your investment away.

<sup>12</sup> Excerpt from "State of the Art: An Executive Briefing on Cutting-Edge Practices in American Angel Investing," p. 155, The Darden School Batten Institute University of Virginia 2003

- ▶ **Use professional service providers** who are familiar with all aspects of early-stage investing and your specific investment structure. Regulations contain many unexpected and undesirable tax consequences, and certain combinations of terms or even phrases can have negative results.
- ▶ **Double-check due diligence** and ask yourself: Are all areas covered? Was information objectively reviewed? Is the company structured appropriately for investment? Do you understand the reasons for investment? Do you understand the risks and potential for return on investment?

INVESTMENT STATISTICS: *Looking again at the results of the 2003 CVR angel group survey, we find:*

- ▶ *70% of responding angel groups leave investment decisions up to the individual members.*
- ▶ *23% of the angel groups invest by majority group decision.*
- ▶ *Of those that invest by majority decision, 90% are structured as LLCs, which is the preferred fund structure. This is further reflected in the unanimous response to a question on pooled investment funds, for which all affirmative respondents were LLCs.*
- ▶ *7% of angel groups invest through investment committee decision.*
- ▶ *No responding angel group required unanimous decision for investment.*

- ▶ **Be realistic.** Investing in any venture has risk, and early-stage investing represents particularly high risk, with little or no company track record, no market, and unproven technology. An investor must have the capacity and willingness to lose his or her entire investment.
- ▶ **Do not put all your investment eggs in one basket.** A balanced portfolio will help ease the pain of a bad investment decision. Do not expect all, or even most of your investments to be homeruns. Statistics are not in your favor. Most angel investors continue this form of high-risk investing because their overall, long-term return is positive and because of personal satisfaction and interest in working with entrepreneurs.

As with the **Building the Framework** part of this Guidebook, stay nimble and willing to accommodate your group's changing needs. This means good up-front development with contingency planning. But most importantly, have fun. Enjoy the entrepreneurs you choose to work with or invest in, enjoy the investment process, and enjoy spending time with your group members.

*Good luck.*

# APPENDIX 1

## ANGELS ANONYMOUS<sup>1</sup> MEMBERSHIP INFORMATION

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### WHAT IS ANGELS ANONYMOUS?<sup>2</sup>

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Angels Anonymous (AA) facilitates the introduction of entrepreneurs to potential investors through presentations and other mechanisms. AA consists of individual angel investors interested in financing privately held companies or ventures typically in an early stage of development.

AA is focused on potential investments in the biopharmaceutical area. Potential members must have prior experience in the biopharmaceutical market or a strong desire, willingness, and capability to learn substantive components of the biopharmaceutical industry.

### HOW DO I BECOME A MEMBER?

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#### REQUIREMENTS OF MEMBERSHIP:

- ▶ Members must qualify as:

An “accredited investor” as defined under Rule 501 of the SEC regulations, which defines an individual accredited investor as: “Any natural person whose individual net worth or joint net worth with that person’s spouse at the time of his purchase exceeds \$1,000,000”; OR “Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.”

- ▶ Members must be \_\_\_\_\_.<sup>3</sup>
- ▶ Members must be sponsored by a current member.
- ▶ Members must agree to abide by the terms and conditions of the AA Membership Agreement.
- ▶ Members must pay annual membership fee.
- ▶ Members must make minimum angel investments of \$\_\_\_\_\_ per year.<sup>4</sup>

<sup>1</sup> “Angels Anonymous” is a fictitious angel group and is merely a name used for example purposes.

<sup>2</sup> This information document uses an example of an angel organization with a specific investment focus, namely, biopharmaceutical, to call attention to the need to identify such membership requirements in the information documents and all other communications. If your group has other restrictions such as gender, those should be specifically noted in all information communications.

<sup>3</sup> Here is where specific requirements of membership may be added such as prior angel investing experience, industry experience, gender, geographic location, etc.

<sup>4</sup> A minimum investment requirement is becoming more prevalent; though required investing does not necessarily have to be through the angel group.

### PROCESS FOR MEMBERSHIP QUALIFICATION:

- ▶ Qualifying individuals are invited to consider becoming members of Angels Anonymous. Membership is at the discretion of AA's Membership Committee and is subject to annual renewal, non-renewal, revocation or termination by AA's Membership Committee.
- ▶ Interested parties must complete the Membership Agreement and Membership Survey, and submit the same as directed on the Membership Agreement.
- ▶ The Membership Committee will review all applications for membership and endeavor to provide applicants with a written response within thirty (30) days of completed application submission. (Your payment, whether by check or credit card, will be held for processing until after your membership has been approved.)
- ▶ AA membership may be terminated or membership revoked at the discretion and determination of AA Membership Committee, should it be determined that an AA member has breached any term of AA membership. A member will be notified in writing by the Membership Committee of the intent to terminate or revoke membership, and the on-notice member shall have thirty (30) days in which to submit a written response to the Membership Committee, should the member deem his/her actions or inactions do not warrant or qualify for termination or revocation of membership. The Membership Committee shall consider, in good faith, such on-notice member written response within sixty (60) days. The decision of the Membership Committee is final.



## WHAT ARE THE BENEFITS OF MEMBERSHIP?

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- ▶ Events – Monthly investor luncheon meetings with presentations from two to four pre-screened companies for members' investment consideration. Afterward, there will be time for discussion of members' observations and analysis.
- ▶ Access to "Members Only" section of the Web site, which includes:
  - ▶ Access to all deal flow through AA's online database.
  - ▶ Copies of all presentations and materials provided at meetings.
  - ▶ Member Discussion Areas online forums to confidentially discuss or comment on business plans, companies and general angel investing topics with other members.
  - ▶ Best-practice sharing of investment tips and documents.
- ▶ Educational programs in term sheets, balanced investment portfolios, case studies, due diligence and other topics in angel investing.
- ▶ Opportunity to interact with other angel investors and meet individuals experienced in working with young companies.

## FREQUENTLY ASKED QUESTIONS

### ▶ What is an angel investor?

An angel investor is an individual who makes direct investments of personal funds into a venture, typically early-stage businesses. Because the capital is being invested at a risky time in a business venture, the angel must be capable of taking a loss of the entire investment, and, as such, most angel investors are high-net-worth individuals. These individuals are nearly always "accredited investors" as defined under the Securities Act of 1933.<sup>5</sup>

<sup>5</sup> "Accredited Investor" as defined in the Securities Act of 1933 for individuals means: "a natural person who has individual net worth or joint net worth with the person's spouse that exceeds \$1 million at the time of the purchase;" OR "a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year."

► **What is an angel group?**

An angel group is a formal or informal assemblage of active angel investors who cooperate in some part of the investment process. Key characteristics of an angel group are: control by member angels (who manage the entity or have control over the entity's managers), and collaboration by member angels in the investment process.

► **Is membership in AA restricted?**

Yes. Please see the description of membership requirements above, and review the entire content of the Membership Agreement.

► **How do I learn more about angel investing?**

AA conducts periodic training programs for new members as an intensive introduction to angel investing. Periodically, AA has speakers on relevant topics as part of the monthly meetings. Members also learn from other experienced angel investor group members.

## **FURTHER QUESTIONS**

► **Other questions that should be answered in your membership-information document include:**

- Must I make a minimum number (or amount) of investments each year in order to remain a member?
- Is there a minimum or maximum amount of money I may invest?
- How will investment decisions be made?
- How will presenting companies be selected?
- May I invest in addition to the amount invested by the group?
- How is due diligence conducted?
- How is AA run? (Administration, board, etc.)
- How is AA funded?

## APPENDIX 2<sup>1</sup>

### ANGELS ANONYMOUS<sup>2</sup> MEMBERSHIP AGREEMENT

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Angels Anonymous (AA) facilitates the introduction of entrepreneurs to potential investors through presentations and other mechanisms. AA consists of individual angel investors interested in financing privately held companies or ventures typically in an early stage of development. Membership in AA is a privilege, which is subject to renewal, revocation, or termination for a member's failure to conduct him or herself in a manner consistent with AA's **(one or more of the following: By Laws; Code of Conduct; Code of Ethics; Confidentiality Requirements; this Membership Agreement; Operating Agreement; Membership Requirements)**.

#### PROCESS FOR MEMBERSHIP QUALIFICATION:

- ▶ Qualifying individuals are invited to consider becoming members of Angels Anonymous. Membership is at the discretion of AA's Membership Committee and is subject to annual renewal, non-renewal, revocation, or termination by AA's Membership Committee.
- ▶ New members must be sponsored by a current AA member.
- ▶ All new members (and renewing members) must complete this Membership Agreement and the Membership Survey.
- ▶ Applications and Surveys may then be forwarded by email or mail to AA at the addresses noted below.
- ▶ The Membership Committee will review all applications for membership and endeavor to provide applicants with a written response within thirty (30) days of completed application submission. (Your payment, whether by check or credit card, will be held for processing until after your membership has been approved.)
- ▶ AA membership may be terminated or membership revoked at the discretion and determination of AA Membership Committee, should it be determined that an AA member has breached any term of AA membership. A member will be notified in writing by the Membership Committee of the intent to terminate or revoke membership, and the on-notice member shall have thirty (30) days in which to submit a written response to the Membership Committee, should the member deem his/her actions or inactions do not warrant or qualify for termination or revocation of membership. The Membership Committee shall consider, in good faith, such on-notice member written response within sixty (60) days. The decision of the Membership Committee is final.

<sup>1</sup> For angel organizations in which members make their own investment decisions. Attributes may also be used for a Code of Membership Conduct/Ethics.

<sup>2</sup> "Angels Anonymous" is a fictitious angel group and is merely a name used for example purposes.

Name: \_\_\_\_\_

Address: \_\_\_\_\_

Phone: \_\_\_\_\_ Fax: \_\_\_\_\_

Email: \_\_\_\_\_

New Member: \_\_\_\_\_ Renewing Member: \_\_\_\_\_

If New member, Sponsoring Current AA Member: \_\_\_\_\_

**TO QUALIFY FOR MEMBERSHIP, I AGREE THAT:**

- ▶ I am an accredited investor as defined under Rule 501 of the SEC regulations, which defines the same as:  
“Any natural person whose individual net worth or joint net worth with that person’s spouse at the time of his purchase exceeds \$1,000,000”; OR “Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” **OR**
- ▶ I have such knowledge and experience in financial and business matters to be capable of evaluating the relative merits and risks of any investment.\*
- ▶ I agree to abide by the terms and rules of AA’s (**one or more of the following: By Laws; Code of Conduct; Code of Ethics; Confidentiality Requirements; this Membership Agreement; Operating Agreement; Membership Requirements**).

\* In order to maintain a high investment profile, AA will accept only a minimal number of sophisticated, but not accredited investors. Therefore, if you do not meet the definition of an “accredited investor,” you may not qualify for membership.

- ▶ I understand that AA is not a venture fund, investment bank, broker/dealer, investment clearinghouse, investment portal, or any other form of investment advisor or otherwise, and is not registered with the Securities and Exchange Commission or any state securities commission. AA does not provide advice, recommendation, or any other indication of appropriateness or inappropriateness for a particular investment. AA does not endorse any investment opportunity and makes no independent investigation to verify information provided by companies submitting to AA for presentation or otherwise, and makes no representation or warranty regarding the same.
- ▶ I must conduct my own analysis and due diligence to determine the appropriateness of any investment I make in any company to which I am introduced through AA. As a result, I recognize and agree that neither AA nor its representatives or agents are responsible or liable for any investment decision I make as a result of being a member of AA. The choice to use and the manner of utilization of information and knowledge gained through AA is my individual and personal choice.
- ▶ I understand that any purchase of equity or other investment transaction shall be with the respective company, without involvement of, or participation by AA.
- ▶ I understand that AA meetings are not an offer to sell or solicitation to buy any security by AA or any other entity.
- ▶ I agree to pay the annual membership dues as set by AA.

### **MEMBERSHIP CODE OF CONDUCT:**

- ▶ I will conduct myself in a professional manner at all times.
- ▶ I will respect the privacy of other members and not provide their name to any third party without their permission.
- ▶ I will keep membership information confidential.
- ▶ I understand and recognize that AA meetings and communications are focused on investment pursuits and will not solicit another member for business.
- ▶ I will disclose to the group any relationship I have or may have with a presenting company, including any personal gain I may receive from the company.

### **DISCLAIMER:**

AA is not a venture fund, an investment bank, a broker dealer, investment clearing-house, or an investment advisor, but rather a forum in which investors may be educated on aspects of investment and business, as well as introduced to companies for possible investment. AA is not registered with the Securities Exchange Commission or any state securities commission. Each member of AA is responsible for his or her own investment decisions, and AA is not recommending any particular company for investment. All investments in entrepreneurial companies involve a high degree of risk, and investors should be able to bear the risk of complete financial loss. The choice to use and manner of utilization of information and knowledge gained through AA is each member's individual and personal choice. No guidance shall be given, nor shall any person affiliated with AA (or AA itself) be responsible for an individual member's use of the information, investment decision, or the results of any investment. AA does not conduct any investigation to verify the factual information submitted to potential investors by individual entrepreneurs. Hence, AA makes no representations or warranties regarding these companies. Investors must conduct their own due diligence and negotiate the terms of any investment they elect to make.

**Please forward with your application (preferably in electronic form) to:**

Angels Anonymous  
1234 Main Street  
Investor City, MI 55555  
Email: membership@angelsanonymous.com

Read, understood, and agreed to by:

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Submitting Applicant Member

Please submit this membership agreement with annual membership dues of \$ \_\_\_\_\_. Please make the check payable to Angels Anonymous, or complete the credit card information below. Your check will not be cashed nor credit card charged unless and until your application for membership has been accepted:

Payment:

Check \_\_\_\_\_ Via \_\_\_\_\_ MC \_\_\_\_\_ Card# \_\_\_\_\_ Exp. \_\_\_\_\_

Complete membership submission includes:

- ▶ Completed membership agreement
- ▶ Completed membership survey
- ▶ Payment

## APPENDIX 3

### ANGELS ANONYMOUS<sup>1</sup> MEMBERSHIP SURVEY

Angels Anonymous (AA) is keenly interested in providing members with maximum benefit, which is aligned with member interests. One of the few ways we have to better understand these interests is to conduct membership surveys and carefully review the results for trends, such as: 1. investment interests; 2. need for expertise among membership; and 3. membership skills which may be valuable to the group as well as portfolio companies. Individual data will be treated confidentially and will not be shared internally or externally; only selected AA Board members will be privy to individual responses. The survey results may be used in aggregate to present AA as an entity to venture capitalists, businesses, and the media for the purpose of securing high-quality deal flow, membership, and public relations.

#### COMPLETION OF THIS SURVEY IS A CONDITION OF MEMBERSHIP, NEW OR RENEWING

<b>1. What is your membership status?</b>	<input type="checkbox"/> New	<input type="checkbox"/> Renewing
<b>2. Have you ever been an angel investor?</b>	<input type="checkbox"/> No	<input type="checkbox"/> Yes
a. If yes, how long?	_____ year(s)	
b. If yes, how many companies have you invested in as an angel investor?	_____ (number)	
<b>3. In what industry(s) do you have professional experience? (check all that apply)</b>		
<input type="checkbox"/> Health care	<input type="checkbox"/> Telecommunications	<input type="checkbox"/> Media
<input type="checkbox"/> Biotechnology	<input type="checkbox"/> Business/Financial	<input type="checkbox"/> Energy
<input type="checkbox"/> Software	<input type="checkbox"/> Consumer Products	<input type="checkbox"/> Agriculture
Other: _____		
<b>4. What business skills/expertise do you have? (check all that apply)</b>		
<input type="checkbox"/> Senior management	<input type="checkbox"/> Board member	<input type="checkbox"/> Operations
<input type="checkbox"/> Research and development	<input type="checkbox"/> Financial services	<input type="checkbox"/> Strategic planning
<input type="checkbox"/> Insurance	<input type="checkbox"/> Legal	<input type="checkbox"/> Public relations
<input type="checkbox"/> Marketing		
<input type="checkbox"/> Business plan development		
<input type="checkbox"/> Infrastructure		
<input type="checkbox"/> Sales		
<input type="checkbox"/> Employee benefits		
<input type="checkbox"/> Accounting		
<b>5. Have you ever been a company founder or officer? (check all that apply)</b>		
<input type="checkbox"/> Founder	<input type="checkbox"/> CEO	<input type="checkbox"/> President
<input type="checkbox"/> CIO	<input type="checkbox"/> COO	<input type="checkbox"/> VP – Sales and Marketing
<input type="checkbox"/> VP – R&D		
<input type="checkbox"/> CFO		

<sup>1</sup> “Angels Anonymous” is a fictitious angel group and is merely a name used for example purposes.



**IF YOU ANSWERED YES TO QUESTION 2, PLEASE COMPLETE THE FOLLOWING QUESTIONS**

**6. As an angel investor, what is the typical stage a company is in at the time of your first investment?** (give percent for each, totaling 100%)

Start-up/seed \_\_\_\_\_%      Early stage \_\_\_\_\_%      Expansion \_\_\_\_\_%  
 Later stage \_\_\_\_\_%      Mezzanine to IPO \_\_\_\_\_%      Public \_\_\_\_\_%

**7. As an angel investor, what is the typical relationship you have with portfolio companies?** (check all that apply)

☐ Board member      ☐ Advisor/mentor      ☐ Officer      ☐ Employee      ☐ Consultant  
☐ Passive      ☐ Other: \_\_\_\_\_

**8. As an angel investor, what has been your typical investment range?** (give percent for each, totaling 100%)

Under \$5,000 \_\_\_\_\_%      \$5,000 to \$10,000 \_\_\_\_\_%      \$10,000 to \$25,000 \_\_\_\_\_%      \$25,000 to \$50,000 \_\_\_\_\_%      \$50,000 to \$100,000 \_\_\_\_\_%  
 \$100,000 to \$500,000 \_\_\_\_\_%      \$500,000 to \$1 Million \_\_\_\_\_%      More than \$1 Million \_\_\_\_\_%

**9. If a renewing AA member, have you invested in any AA presenting companies?**

☐ No      ☐ Yes

If yes, which company(s)? \_\_\_\_\_  
 If no, why not? \_\_\_\_\_

**10. What is your preferred form of investment?** (rank with 1 highest)

Equity \_\_\_\_\_      Debt \_\_\_\_\_      Combination \_\_\_\_\_      Case by case \_\_\_\_\_

**11. What is your general expectation on length of time until return on investment?**

☐ Less than 1 year      ☐ 1 to 3 years      ☐ 3 to 5 years      ☐ More than 5 years

**12. In what industries have you invested?** (check all that apply)

☐ Health care      ☐ Telecommunications      ☐ Media      ☐ Manufacturing      ☐ Environment  
☐ Biotechnology      ☐ Business/Financial      ☐ Energy      ☐ E-Commerce      ☐ Industrial  
☐ Software      ☐ Consumer Products      ☐ Agriculture      ☐ Hardware      ☐ Semiconductor  
 Other: \_\_\_\_\_

**13. What has been your historical angel investment rate of return?**

☐ Negative      ☐ 0% to 10%      ☐ 10% to 30%      ☐ 30% to 50%  
☐ 50% to 100%      ☐ 100% to 200%      ☐ More than 200%

**14. What do you enjoy about being part of AA or any angel group?** (rank all that apply, with 1 highest)

Deal flow \_\_\_\_\_      Education \_\_\_\_\_      Camaraderie/social \_\_\_\_\_      Joint due diligence \_\_\_\_\_      Meeting companies \_\_\_\_\_  
 Shared expertise \_\_\_\_\_      Administrative support \_\_\_\_\_      Professional support \_\_\_\_\_      Guest speakers \_\_\_\_\_      Other \_\_\_\_\_

**15. How would you rate your overall satisfaction with AA?** \_\_\_\_\_ 1 – 5 (1 highest)

**16. How might we improve AA and your membership experience?**

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Name: \_\_\_\_\_

Thank you for completing this survey.

## APPENDIX 4

### ANGEL INVESTOR EDUCATION PROGRAM AGENDA

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TOPIC	CONTENT	MATERIALS
<b>I Introduction:</b> <b>A. What is Angel Investing?</b>	<b>1. What is an “angel investor?”</b> <b>a.</b> Historically, “angels” were individuals who financed Broadway productions <b>b.</b> Accredited Investor under the SEC rules and regulations: <ul style="list-style-type: none"> <li>Individual annual income of \$200,000 or joint of \$300,000</li> <li>Net worth of \$1,000,000</li> </ul> <b>c.</b> Angel investing statistics: <ul style="list-style-type: none"> <li>Funding gap</li> <li>Angels invest more per year than VCs</li> </ul> <b>d.</b> Characteristics of an angel investor: <ul style="list-style-type: none"> <li>Invest locally, desiring to give back to their community and prefer to be close to their investments</li> <li>Often successful entrepreneurs</li> <li>Looking for different investment model</li> <li>Interested in a return on investment</li> <li>Typically early stage before venture financing or with VC financing</li> </ul> <b>2. Why be an Angel Investor?</b> <b>a.</b> Significant possible upside: In recent years, VC investments have boasted high returns <b>b.</b> Possible involvement in company <b>c.</b> Helping entrepreneurs: rewarding <b>3. Why <i>not</i> be an angel investor?</b> <b>a.</b> High risk <b>b.</b> Invest only what you can lose <b>c.</b> Stressful <b>4. Options for angel investing</b> <b>a.</b> Independently <b>b.</b> Angel organizations and structure <b>c.</b> Relationship with company	<ul style="list-style-type: none"> <li>Regulation D</li> <li>Partial reprints from selected materials on angel investing</li> <li>Case studies</li> </ul>

TOPIC	CONTENT	MATERIALS
<b>B. Deal Flow</b>	<ul style="list-style-type: none"> <li>a. Angel group members</li> <li>b. Other angel networks and investment groups</li> <li>c. Investment forums <ul style="list-style-type: none"> <li>▸ Generally screened so “best of breed”</li> <li>▸ Industry/technology focused, or just early stage</li> <li>▸ Interact and learn from experienced angel investors</li> </ul> </li> <li>d. Venture capitalists</li> <li>e. Investment bankers</li> <li>f. Professionals: lawyers, accountants, bankers</li> <li>g. Professional/business journals</li> <li>h. Internet</li> </ul>	
<b>II Due Diligence: A. The Process</b>	<ul style="list-style-type: none"> <li>a. How and when to use consultants and other third parties</li> <li>b. Process: What to ask; how to ask; when to ask</li> <li>c. Internet searching; Federal and state searches</li> <li>d. Expectations</li> <li>e. Sources for market analysis</li> <li>f. Sources of comparables: <ul style="list-style-type: none"> <li>▸ Recent IPOs (10Ks, annual reports)</li> <li>▸ Recent companies funded in this space</li> <li>▸ Venture One, Edgar, investment banks</li> <li>▸ Verify financial model via comparables</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▸ Due diligence checklists</li> <li>▸ Due diligence request letter</li> <li>▸ List of independent analysis resources</li> </ul>
<b>B. Governance/Business Structure</b>	<ul style="list-style-type: none"> <li>a. What are the corporate structural options and the advantages and disadvantages of each from an investor’s perspective? C corp. v. S corp. v. LLC v. LP</li> <li>b. Board of directors and advisory boards</li> <li>c. Internal structure</li> <li>d. Shareholder structure and options</li> <li>e. Typical ownership percentages for founders, key management, etc.</li> <li>f. What dilution means and how to calculate</li> <li>g. Various liquidity options</li> <li>h. Founder share allocations and vesting</li> </ul>	<ul style="list-style-type: none"> <li>▸ Table comparison explaining different attributes of each structure (tax, shareholder liability, ownership restrictions, etc.)</li> <li>▸ Sample capitalization table showing various types of ownership and shareholder status</li> <li>▸ Representative documents</li> <li>▸ Example dilution tables</li> </ul>

TOPIC	CONTENT	MATERIALS
<b>B. Governance/Business Structure</b> (continued)	<ul style="list-style-type: none"> <li>i. Organizational structure: options</li> <li>j. Option plans: what are they and importance</li> <li>k. Dilution upon investment</li> </ul>	
<b>C. Financials</b>	<ul style="list-style-type: none"> <li>a. How to read them</li> <li>b. What to look for</li> <li>c. GAAP basics</li> <li>d. Valuations</li> <li>e. Financial assumptions and revenue sources</li> </ul>	<ul style="list-style-type: none"> <li>▸ Sample financials</li> <li>▸ Typical assumptions</li> <li>▸ Valuation options</li> </ul>
<b>D. Market</b>	<ul style="list-style-type: none"> <li>a. Market-size assessments and questions to ask</li> <li>b. Competitive assessments and questions to ask</li> </ul>	<ul style="list-style-type: none"> <li>▸ Sample market plan</li> <li>▸ List of market-information sources</li> </ul>
<b>E. Management</b>	<ul style="list-style-type: none"> <li>a. How to determine if the team fits the company</li> <li>b. What makes a good team?</li> <li>c. How to conduct interviews and reference checks</li> <li>d. How to analyze management receptiveness to input and flexibility</li> </ul>	<ul style="list-style-type: none"> <li>▸ List of management attributes to consider</li> <li>▸ List of key management positions</li> <li>▸ List of industry-specific needs</li> <li>▸ Questions for employee and reference interviews</li> </ul>
<b>F. Intellectual Property</b>	<ul style="list-style-type: none"> <li>a. How to conduct a technology assessment/audit</li> <li>b. The basics of intellectual property</li> <li>c. How to determine if adequate systems in place to identify and protect IP</li> <li>d. How to use technology experts for analysis</li> </ul>	<ul style="list-style-type: none"> <li>▸ Technology audit checklist</li> <li>▸ IP vignettes on patents, copyright and trademark</li> <li>▸ List or samples of company IP-protection documents such as employee confidentiality and inventions agreement</li> <li>▸ IP decision process and procedure</li> </ul>
<b>G. Operations</b>	<ul style="list-style-type: none"> <li>a. Components of a good operations plan</li> <li>b. Relationship to financials and marketing plan</li> </ul>	<ul style="list-style-type: none"> <li>▸ Sample plan</li> </ul>

TOPIC	CONTENT	MATERIALS
<b>III Term Sheets</b>	<ul style="list-style-type: none"> <li>a. What is a private placement?</li> <li>b. What is the investment process?</li> <li>c. What should one expect?</li> <li>d. What are deal-structure options? <ul style="list-style-type: none"> <li>▸ Common vs. preferred</li> <li>▸ Rights, preferences, and privileges</li> </ul> </li> <li>e. Negotiating term sheets <ul style="list-style-type: none"> <li>▸ Mock negotiations</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▸ Example Term Sheet (annotated)</li> <li>▸ Definitions glossary</li> <li>▸ Case Studies</li> </ul>
<b>IV After the Investment</b>	<ul style="list-style-type: none"> <li>a. Level of Involvement <ul style="list-style-type: none"> <li>▸ Monitoring or participating</li> <li>▸ Relationship to investment amount</li> <li>▸ Individual vs. group investment</li> <li>▸ Potential liabilities for board positions</li> </ul> </li> <li>b. What You Want <ul style="list-style-type: none"> <li>▸ Information Rights (financials, annual reports, business plans)</li> <li>▸ Ability to attend Board meetings</li> </ul> </li> </ul>	

## APPENDIX 5

### GROUP FINANCES: REVENUES AND EXPENSES WORKSHEET \*

REVENUES	MONTHLY BUDGET	ANNUAL BUDGET
Membership dues		
Venture capital member dues		
Sponsorships		
Company Application Fees		
Presenter Fees		
Endowment/donations – 501(c)(3) only		
Events		
Publications		
In-kind contributions/sponsorships (with corresponding expense coverage noted)		
<b>Total Revenues</b>		
EXPENSES **	MONTHLY BUDGET	ANNUAL BUDGET
Manager/Executive Director and/or administrative support (salary plus possible benefits)		
Web site development/maintenance		
Meetings		
Member relations and communications/correspondence		
Public relations		
Office expenses		
Programs/events		
<b>Total Expenses</b>		

\* Modified balance sheet to show only revenues and expenses

\*\*See Table 11 in the Guidebook for possible expenses and for expanded explanation and discussion of possible expense categories and range of costs

## APPENDIX 6

### ANGELS ANONYMOUS<sup>1</sup> FUNDING APPLICATION<sup>2</sup>

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*[Note: Company applications should be limited to an executive summary or response to specific questions. Accepting entire business plans can be an exercise in futility as business plans can often exceed 30 to 40 pages, in addition to attachments. Members seldom have the time or patience to read through numerous, lengthy business plans, and often the essential information needed for this initial screening step is not readily apparent in a large document.]*

*You should also have a page limit for the company application. Requiring answers to specific questions, as opposed to accepting executive summaries, gives greater assurance of receiving all information your screening committee desires in reviewing applications, but you risk losing the unique story-telling quality that an executive summary has, which often tells you much about management style and communication skills. Additionally, some companies will not want to take the time (or have the time) to answer a series of questions, and these are often the “hot deals” that do not need to go through additional processes to raise money. The brevity requirement may seem harsh, but through experience, the companies able to clearly articulate their mission, product, market, and future in five pages or less most likely have the greatest chance for success.]*

**Please submit your executive summary of NO MORE THAN FIVE PAGES (including attachments, appendices and exhibits), which contains information on the subjects identified below. Materials beyond the five-page limit will not be reviewed or considered. The list below is not intended to suggest any particular order of information, but rather the entrepreneur should consider the arrangement best suited for describing his/her company.**

<sup>1</sup> “Angels Anonymous” is a fictitious angel group and is merely a name used for example purposes.

<sup>2</sup> Note: The submission process described in this document is for angel groups in which members select presenting companies through a screening committee structure. If your group is manager led, your manager will likely do screening, which can facilitate receiving more information from companies and provide for a more intensive up-front review process. As discussed in the Guidebook, MBA students can also be valuable in conducting initial screening of applicant companies.



### **SUBMISSION CONTENT:**

- ▶ The Company
  - ▶ History, including accomplishments to date
  - ▶ Mission
- ▶ Product(s)/Services
  - ▶ Description of product(s)/services
  - ▶ Ownership
  - ▶ Development stage
  - ▶ Timing of, and process to, commercialization
  - ▶ Unique attributes and opportunities
- ▶ Market
  - ▶ Size and definition
  - ▶ Industry trends
  - ▶ Needs for product(s)/services
  - ▶ Customers
  - ▶ Sales/distribution plan
  - ▶ Necessary partnerships and status
- ▶ Competition
  - ▶ Comparative analysis, including key features and benefits
  - ▶ Competitive advantage/market differentiators
  - ▶ Barriers to entry for competitors and company
- ▶ Management
  - ▶ Experience of all senior management, including previous start-ups
  - ▶ Previous experience working together
  - ▶ Needs/key vacancies
  - ▶ Board of Directors
  - ▶ Advisors

- Financials
  - Founder's investment
  - Fully-diluted capitalization table (i.e., including options, warrants, and debt)
  - Summary projected financials (one and three to five years)
  - Funding needs for this round and subsequent rounds
  - Use of funds
  - Exit strategy and timing
  - Business milestones for next six months and next two years

### **SUBMISSION PROCESS:**

- All executive summaries received by the 5th of the month<sup>3</sup> will be considered for presentation at the member investment meeting held in the same month. Any submissions after the 5th of the month will be held for the following month's review and consideration. Companies must submit executive summaries on-line through the Web site at [www.angelsanonymous.com](http://www.angelsanonymous.com) or directly to [submissions@angelsanonymous.com](mailto:submissions@angelsanonymous.com).
- Submissions must be accompanied by a payment of the processing fee of \$100, which is payable on-line at [www.angelsanonymous.com](http://www.angelsanonymous.com). Companies failing to make such payment will not be considered by the screening committee.
- All executive summaries are posted under a members-only section of AA's Web site and will remain posted for approximately 120 days.
- The screening committee will consider all timely filed and completed submissions and will inform selected companies by the 12th of each month.<sup>4</sup> Non-selected companies will be informed by the 15th of each month and will receive standardized feedback from the screening committee.
- Selection criteria are based on review of each executive summary against a screening matrix, a copy of which is available on the AA Web site.

<sup>3</sup> Should any date fall on a Saturday, Sunday or holiday, the date will be extended to the next business day.

<sup>4</sup> Note: An additional step you may wish to consider is selection of semi-finalists, who are then personally interviewed to make the final selection of presenting companies. This process works well for manager-led angel groups.

- ▶ Selected companies must agree to coaching in preparation for their presentation at the member investment meeting. Coaching sessions will be scheduled at the time of selection notification.
- ▶ **Materials for Member Investment Meeting:** Selected companies must give a PowerPoint or equivalent presentation of no more than 15 minutes in length, followed by a five- to-seven-minute Q&A period. Copies of the presentation must be provided to members at the investment meeting and an electronic copy provided to AA for posting under the members-only section of the AA Web site. Companies may offer other materials at the member investment meeting. Space will be made available for a company display or demonstration immediately prior to, during, and after the investment meeting.
- ▶ Neither investment solicitation nor commitment will be made at the member investment meeting, and presenting companies are expected to bring with them information on the timing and location for a follow-on meeting with interested AA members.
- ▶ Any questions should be directed to [submissions@angelsanonymous.com](mailto:submissions@angelsanonymous.com).

## APPENDIX 7

### ANGELS ANONYMOUS<sup>1</sup> SCREENING COMMITTEE WORKSHEET

Scoring: 1= Unsatisfactory   2= Weak   3= Satisfactory   4= Good   5= Excellent

CATEGORY AND QUESTIONS	SCORE				
General Information					
Was all requested information submitted?	1	2	3	4	5
Was the overall content understandable and well presented?	1	2	3	4	5
Did the applicant stay within the page-submission requirement?	1	2	3	4	5
Products/Services					
Are the company product/services adequately described?	1	2	3	4	5
Is the ownership well understood?	1	2	3	4	5
Is it clear that the company owns or has licensed all relevant technology?	1	2	3	4	5
If the company is dependent on patents or other intellectual property ownership rights to succeed, has the company obtained such protection or taken all steps to date to obtain such protection?	1	2	3	4	5
Are there large industry competitors which could engineer around the company's patents?	1	2	3	4	5
Do the product/services solve a current market issue?	1	2	3	4	5
Are there unique attributes to the product/services which provide market differentiation?	1	2	3	4	5
Is this a single product/service company or a suite of potential products/services applicable to more than one market? (1: single/narrow niche to 5: numerous/highly diverse)	1	2	3	4	5
Market					
Is the market adequately described?	1	2	3	4	5
Is the market realistic?	1	2	3	4	5
Is there a well-defined marketing plan, including distribution?	1	2	3	4	5
What is the size and scope of the market? (1: Less than \$10 Million and regional to 5: Greater than \$1 Billion and global)	1	2	3	4	5
Is the market considered a growth market?	1	2	3	4	5
Is the customer base well defined, including compelling reasons for customer purchase?	1	2	3	4	5

<sup>1</sup> "Angels Anonymous" is a fictitious angel group and is merely a name used for example purposes.

CATEGORY AND QUESTIONS	SCORE				
<b>Market</b> (continued)					
Is there a need for follow-on customer relationships (e.g., maintenance services), and, if so, has this been well defined and addressed?	1	2	3	4	5
Has the company established all necessary partnerships, whether service providers, manufacturers, distributors, or third-party developers?	1	2	3	4	5
<b>Competition</b>					
Does the company recognize competitors?	1	2	3	4	5
Has the company done a competitive analysis, with attention to key features and benefits?	1	2	3	4	5
Has the company fairly analyzed and compared or contrasted itself with the competition?	1	2	3	4	5
Does the company present a strong and factually based reasoning for its competitive advantage?	1	2	3	4	5
Are you aware of other players in the market that the company has not identified?	1	2	3	4	5
Does the company need a first-mover position?	1	2	3	4	5
If a first-mover position is needed, will the company have adequate financial resources and/or first-to-market timing advantage to make this approach succeed?	1	2	3	4	5
<b>Management</b>					
Does management have adequate experience and expertise to properly build the company?	1	2	3	4	5
Is the management team complete?	1	2	3	4	5
If not complete, does management recognize these needs?	1	2	3	4	5
Has the management worked together before?	1	2	3	4	5
Has management been previously funded?	1	2	3	4	5
Does the Board of Directors include outside directors?	1	2	3	4	5
Does the Board have a diversity of skills and background?	1	2	3	4	5
Does the company have a Board of Advisors?	1	2	3	4	5

CATEGORY AND QUESTIONS	SCORE				
Financials					
Has the company provided adequate and understandable current and projected financial statements?	1	2	3	4	5
Are the company's projections realistic?	1	2	3	4	5
Do the financials show a viable and sustainable revenue model?	1	2	3	4	5
Has the company adequately considered all costs associated with developing and marketing its product/services?	1	2	3	4	5
Has the company articulated the use of raised funds?	1	2	3	4	5
Is the company using the funds to pay off debts? (1: More than 50% used for debt reduction or elimination to 5: No use on debt)	1	2	3	4	5
Has the company considered a reasonable exit strategy?	1	2	3	4	5
Have the founders contributed their own capital into the company?	1	2	3	4	5
Is the company dependent on others for success? (1: Yes, nearly completely to 5: None whatsoever)	1	2	3	4	5
Total Score					

Comments:

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## **APPENDIX 8**

### **ISSUES TO CONSIDER IN DUE DILIGENCE**

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#### **CORPORATE STRUCTURE AND GOVERNANCE** **(REVIEW DOCUMENTS AND INTERVIEW MANAGEMENT, BOARD, AND ADVISORS)**

- ▶ What is the company's corporate structure? C corp., S corp., LLC or LP? Does this model allow for a liquidity event and/or return on investment?
- ▶ Is there an exit strategy?
- ▶ Is the corporate structure overly complicated? If so, why, and might it be simplified?
- ▶ How many existing shareholders? Too numerous, and, if so, why?
- ▶ Does the corporate structure fit with the business model?
- ▶ Does the corporate structure allow for growth?
- ▶ What is the founder share allocation? Do they have a large enough stake to have the incentive to succeed, but not so large as to ignore board and other advisors? Is the founders' stock vested over time?
- ▶ Who is on the board of directors? Do they have the right background for the company? Is there a sufficient number of outside directors? How are board members compensated?
- ▶ Does the company have a board of advisors and, if so, who is on the board? Do the advisors actively participate in the company's development? How are advisors compensated?
- ▶ Has the company been involved in any litigation or been threatened with litigation?
- ▶ Does the company have all required permits and licenses?

#### **FINANCIAL ASSUMPTIONS AND REVENUE SOURCES** **(REVIEW ALL FINANCIAL DOCUMENTS)**

- ▶ Has the company completed one-, three- and five-year financial projections?
- ▶ Have the financial documents been properly developed according to applicable accounting rules?
- ▶ Has the company used an outside, independent accounting firm to compile, review, or audit financials?

- How good are the assumptions? (rate of growth, acceptance rate, pricing, multiple revenue streams, costs)
- Are revenues realistic?
- When does the company reach cash flow positive, and what cash requirements will it take to get there?
- Has the company already received funding, and, if so, how much; what are pre-money valuation and terms?
- What are the follow-on funding requirements and sources? Has the company properly anticipated future needs, and is it already working on those?
- Have all tax returns been properly filed?
- What is the company's debt carry? What are the ratios?
- Is the company's current valuation aligned with its current stage of development and market potential?

## **MARKET ASSESSMENT**

### **(DO INDEPENDENT MARKET ANALYSIS AND REQUIRE CUSTOMER REFERENCES IF APPLICABLE)**

- Does the company's product or service address a new or existing market?
- Is the product or service platform-based, with the opportunity for additional products or services? Or is this potentially a one-trick pony?
- Does the company have a well-thought-out sales and marketing plan?
- Does the company have key relationships in place, or is it working on the same, with marketing and/or sales partners?
- Does the company have or need key joint venture relationships?
- Is the company focused on the appropriate market development, or are they trying to do too much at one time?
- Have they chosen the right first market?
- Does their product or service represent a market push or pull?
- What is the potential market size?



- Have they conducted thorough market research to support their financial assumptions, revenue model, and valuation?
- What is their stage of development? Concept, alpha, beta, or shipping?
- If the company has already introduced its product or service into the market, what is the number of current and potential customers?
- What is the length of its sales cycle?
- What are the channels of distribution?
- Does the company's product or service have a seasonal aspect?
- Is this a stable market and are COGS stable?

### **COMPETITIVE ARENA (DO INDEPENDENT COMPETITIVE ANALYSIS)**

- Who are the company's competitors?
- Has the company realistically assessed its competitors?
- What is the company's market differentiator? Is this enough to make them superior to competition from the customer's perspective?
- Is this a market or product consolidation?
- How entrenched are the competitors?
- What is the financial stability of competitors?
- What does the market share look like?
- How will this company win?
- Has the company done a detailed feature-by-feature analysis?

## **MANAGEMENT TEAM**

### **(INTERVIEW ALL TEAM MEMBERS AND KEY EMPLOYEE REFERENCES)**

- What is the caliber/pedigree of the team?
- What is the team's overall track record?
- Do they have the combined requisite skills and experience?
- Do they recognize limitations in management, and are they seeking candidates?
- Is the management open to discussion and suggestions on improvement to their business model?
- Has the management team been previously funded?
- How are management and all other employees being compensated?
- Does the company have an option plan, and have options been granted to all employees? What percentage do the founders have as compared to other key management?

## **TECHNOLOGY ASSESSMENT**

### **(MAY NEED EXPERT OR PROFESSIONAL ASSISTANCE IN TECHNOLOGY ASSESSMENT)**

- Do they have market requirements and functional specifications?
- At what stage is development? Concept, alpha, beta, shipping?
- Does the company have any usability studies?
- Does the company have adequate intellectual-property protection? Does it need it?
- Is the company relying on being first to market, rather than on any IP position, for competitive advantage, and is this realistic?
- What is product quality assurance like?

- Is it proprietary architecture or open-source code?
- Do they have adequate systems in place to identify and protect IP?
- Who in the company is focused on these issues?
- Has the company properly set up relationships and documentation to ensure ownership of all intellectual property?
- Does the company own all necessary intellectual property through internal development or licenses?
- Do any other companies have potential claims to the IP resulting from previous employment relationships or for any other reason?

## **OPERATIONS**

- Does the company have an operating plan or outline of the same if early stage?
- Has the company considered all aspects of operation to successfully launch a product or service?
- Does the operating plan anticipate growth? Is anticipated growth realistic?
- Has the company received any citations or notices of violation?
- For more mature companies, does each division of the company have an operating plan, and are they compatible?
- Does management meet regularly to ensure compliance with plan or make needed adjustments?
- Has the company been able to stay on plan?
- Does the plan take into consideration all cash needs and anticipated cash flow?
- Does the company have an alternative plan if assumptions do not hold, such as for product rollout, cash needs, and market response?

### **COMPARABLES:**

- Recent IPOs (10Ks, annual reports)
- Recent companies funded in this space
- Third-party (including government) databases, reports, publications, and market analysis
- Comparable financial models

### **WHAT TO WATCH OUT FOR:**

- **Unrealistic valuation (or revenue model)**
  - Affects percentage ownership
  - Affects possible subsequent rounds
  - May end up with “down-round” on next financing
- **Complicated investment terms**
  - Preferred fine, but be careful of other complicated features such as rights of first refusal; onerous liquidation preferences; registration rights; no lock-ups; co-sale
- **Heavy debt**
  - New investment dollars should be used for advancing the company, not for paying old obligations
- **Missing key assumptions about market or financial model**
- **One-trick pony (one-product or -service company)**
- **No board per se**
- **Inexperienced management**
- **Poor advisors**

## APPENDIX 9

### DUE DILIGENCE CHECKLIST TABLE

The documents and materials itemized below constitute a list of materials which should be reviewed for any financing. Keep in mind that many early-stage companies will not have some or many of these documents, as certain events may not have occurred. Request should be made for all documents or disclosures listed below.

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
<b>I.</b>	<b>General corporate materials (The Company, all subsidiaries, partnerships and joint ventures).</b>					
<b>A.</b>	<b>Business Plan</b> , including executive summary, market analysis and plan, operational plan, and complete financials.					
<b>B.</b>	<b>Minutes</b>					
<b>1.</b>	Minutes of stockholders' meetings, including those of any predecessor corporations.					
<b>2.</b>	Minutes of board of directors, including those of any predecessor corporations.					
<b>3.</b>	Minutes of permanent committees of the board, including those of any predecessor corporations.					
<b>4.</b>	Authorizing resolutions relating to this offering and related transactions.					
<b>C.</b>	<b>Charter Documents</b>					
<b>1.</b>	Articles or Certificate of Incorporation, as amended to date, including current drafts of pending charter amendments and recapitalization documents.					
<b>2.</b>	Drafts of documents related to proposed reincorporation.					
<b>3.</b>	Bylaws, as amended to date.					
<b>4.</b>	Good standing (and franchise tax board) certificates.					
<b>5.</b>	List of jurisdictions in which the Company or any of its subsidiaries or affiliates is qualified to do business,					

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
<b>D.</b>	<b>Corporate Organization</b>					
1.	List of officers and directors.					
2.	Management structure organization chart.					
3.	Stockholders' lists (including list of optionees and warrant holders), including number of shares and dates of issuance, and consideration paid.					
4.	Information regarding subsidiaries, i.e., ownership, date of acquisition of stock and/or assets, all closing binders relating to acquisitions.					
5.	Information regarding joint ventures or partnership, i.e., partners, date of formation, all closing binders relating to joint ventures or partnerships.					
6.	Agreements relating to mergers, acquisitions, or dispositions by the Company of its subsidiaries or affiliates of companies, significant assets or operations involving the Company or any of its subsidiaries or affiliates since inception, including those of any predecessor or subsidiary corporations.					
<b>E.</b>	<b>Capital Stock</b>					
1.	Stock records, stock ledgers and other evidence of securities authorized and issued.					
2.	Agreements relating to the purchase, repurchase, sale or issuance of securities, including oral commitments to sell or issue securities.					
3.	Agreements relating to voting of securities and restrictive share transfers.					
4.	Agreements relating to preemptive or other preferential rights to acquire securities and any waivers thereof.					
5.	Agreements relating to registration rights.					

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
6.	Evidence of qualification or exemption under applicable federal and state blue sky laws for issuance of the Company's securities.					
7.	Documents relating to any conversion, recapitalization, reorganization, or significant restructuring of the Company.					
II.	<b>Litigation</b>					
A.	Any litigation, claims, and proceedings settled or concluded, including those of any predecessor corporations and subsidiaries.					
B.	Any litigation, claims, and proceedings threatened or pending. Please include potential litigation—e.g., employees who may be in breach of non-compete agreements with prior employers.					
C.	Any litigation involving an executive officer or director, including executive officers or directors of predecessor corporations and subsidiaries, concerning bankruptcy, crimes, securities law, or business practices.					
D.	Any consent decrees, injunctions, judgments, other decrees or orders, settlement agreements, or similar matters.					
E.	All attorneys' letters to auditors, including those of any predecessor corporation and subsidiaries.					
III.	<b>Compliance with Laws</b>					
A.	Any citations and notices received from government agencies, including those of any predecessor or subsidiary corporations, or with continuing effect from an earlier date.					
B.	Any pending or threatened investigations and governmental proceedings.					

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
<b>C.</b>	All material governmental permits, licenses, etc., of the Company presently in force, together with information regarding any such permits, licenses, etc., which have been canceled or terminated, required to carry out the business or operations of the Company or its subsidiaries or affiliates, including such permits, licenses, etc. required by foreign, federal, provincial, or local authorities, and any evidence of exemption from any such permit or license requirement.					
<b>D.</b>	All documents filed with the SEC or any state or foreign securities regulatory agency, if any.					
<b>E.</b>	Any material reports to and correspondence with any government entity, municipality or government agencies, including the EPA and OSHA, including those of any predecessor corporations or subsidiaries.					
<b>IV.</b>	<b>Employee Matters (Including items regarding any predecessor or subsidiary or affiliated corporations and all items presently in force and drafts of any pending amendments or new items)</b>					
<b>A.</b>	Employee agreements.					
<b>B.</b>	Consulting contracts.					
<b>C.</b>	Employee benefit and profit-sharing plans, including stock option, stock purchase, deferred compensation, and bonus plans or arrangements.					
<b>D.</b>	All other employee compensation, bonus, incentive, retirement, benefit (e.g., Life or health insurance, medical reimbursement plans, etc.), or similar plans.					
<b>E.</b>	Employee Confidentiality and Proprietary Rights Agreement					
<b>F.</b>	Officers and directors questionnaires.					
<b>G.</b>	Contracts with unions and other labor agreements.					



TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
H.	Loans to and guarantees for the benefit of directors, officers or employees.					
I.	"Key person" insurance policies.					
J.	Listing of employees by office and department.					
K.	Affiliation agreements with advertising agencies or public relations firms.					
L.	Stock ownership of directors and of the five most-highly compensated officers.					
V.	<b>Real Property</b>					
A.	Deeds.					
B.	Leases of real property.					
C.	Other interests in real property.					
D.	Any documents showing any certification of compliance with, or any deficiency with respect to, regulatory standards of the Company's or any of its subsidiaries' or affiliates' facilities.					
E.	Financing leases and sale and lease-back agreements.					
F.	Conditional sale agreements.					
G.	Equipment leases.					
VI.	<b>Intellectual Property Matters</b>					
A.	List of all foreign and domestic patents, patent applications, copyrights, patent licenses and copyright licenses held by the Company.					
B.	List of any trademarks, trademark applications, trade names, or service marks.					
C.	Claims of infringement or misappropriation of others' patents, copyrights, trade secrets, or other proprietary rights.					

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
<b>D.</b>	Copies of all agreements in-licensing or acquiring any technology, including without limitation software licenses, patent licenses, or other technology licenses, or any development or joint-development agreements.					
<b>E.</b>	Copies of all agreements out-licensing or selling any technology, including without limitation any software licenses, patent licenses, or other technology licenses, or any distribution, OEM, VAR or sales-representative agreements.					
<b>VII.</b>	<b>Debt Financing</b>					
<b>A.</b>	All debt instruments, credit agreements, and guarantees entered into by the Company, including lease financing, which are currently in effect.					
<b>B.</b>	All material correspondence with lenders, including all compliance reports submitted by the Company or its accountants.					
<b>C.</b>	Any loans and guarantees of third-party obligations.					
<b>D.</b>	Any agreements restricting the payment of cash dividends.					
<b>VIII.</b>	<b>Other Agreements</b>					
<b>A.</b>	Marketing agreements.					
<b>B.</b>	Management and service agreements.					
<b>C.</b>	Forms of secrecy, confidentiality, and nondisclosure agreements.					
<b>D.</b>	Contracts outside the ordinary course of business.					
<b>E.</b>	Indemnification contracts and similar arrangements for officers and directors.					
<b>F.</b>	Agreements with officers, directors, and affiliated parties.					
<b>G.</b>	Any agreements with competitors.					

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
<b>H.</b>	Any agreements with governmental agencies or institutions.					
<b>I.</b>	Any agreements restricting the Company's right to compete or other agreements material to the business.					
<b>J.</b>	Any material insurance arrangements (including property damage, third-party liability, and key employee insurance).					
<b>K.</b>	Agreements requiring consents or approvals or resulting in changes in rights in connection with change-of-control transactions.					
<b>IX.</b>	<b>Financial Information</b>					
<b>A.</b>	Audited/Unaudited financial statements, including those of any predecessor corporations.					
<b>B.</b>	Interim financial statements.					
<b>C.</b>	Budget plan, including revisions to date with respect to the budget plan for the current fiscal year for the Company and its subsidiaries and affiliates.					
<b>D.</b>	The Company's long-range strategic plan, any other documents concerning its long-range plans, and any information concerning the Company's compliance therewith.					
<b>E.</b>	Disclosure documents used in private placements of the Company's or any of its subsidiaries' or affiliates' securities, or institutional- or bank-loan applications since inception.					
<b>F.</b>	Any other material agreements with creditors.					
<b>G.</b>	Significant correspondence with independent public accountants, including management letters.					
<b>H.</b>	Any reports, studies and projections prepared by management on the Company's or its subsidiaries' or affiliates' business, financial condition, or planned operations, including business plan.					

TITLE OF SECTION AND SUBSECTION	DOCUMENTS REQUESTED	SHOULD HAVE	DATE RECEIVED	DATE DELIVERED	REVIEWER'S INITIALS	COMMENTS
<b>I.</b>	Any reports and studies prepared by outside consultants on the Company's or its subsidiaries' or affiliates' business or financial condition.					
<b>J.</b>	Reports and materials prepared for the Company's board of directors or a committee thereof.					
<b>K.</b>	Contracts with investment bankers and brokers.					
<b>X.</b>	<b>Tax Matters</b>					
<b>A.</b>	Federal, state and local tax returns, including those of any predecessor corporations.					
<b>B.</b>	Audit adjustments proposed by the IRS.					
<b>XI.</b>	<b>Acquisitions/Divestitures</b>					
<b>A.</b>	Acquisitions or divestitures (including related documentation).					
<b>B.</b>	Current plans or negotiations relating to potential acquisitions or divestitures.					
<b>XII.</b>	<b>Public Relations</b>					
<b>A.</b>	Annual reports and other reports and communications with stockholders, employees, suppliers, and customers.					
<b>B.</b>	Advertising, marketing, and other selling materials.					
<b>XIII.</b>	<b>Press Releases and Clippings</b>					
<b>A.</b>	Analyst reports.					
<b>XIV.</b>	<b>Miscellaneous</b>					
<b>A.</b>	Supply copies of all market research or marketing studies concerning the Company's business conducted.					
<b>B.</b>	Significant agreements currently in draft stage.					

## APPENDIX 10

### GLOSSARY OF TERMS RELATED TO VENTURE CAPITAL AND OTHER PRIVATE EQUITY OR DEBT FINANCING

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**401(K) Plan:** A type of qualified retirement plan in which employees make salary-reduced, pre-tax contributions to an employee trust. In many cases, the employer will match employee contributions up to a specified level.

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**Accredited Investor:** Rule 501 of the SEC regulations defines an individual accredited investor as: “Any natural person whose individual net worth or joint net worth with that person’s spouse at the time of his purchase exceeds \$1,000,000”; OR “Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” For the complete definition of “accredited investor,” see the SEC web site.

**Accrued Interest:** The interest due on preferred stock or a bond since the last interest payment was made.

**ACRS:** Accelerated Cost Recovery System. The IRS-approved method of calculating depreciation expense for tax purposes. Also known as Accelerated Depreciation.

**ADR:** American Depositary Receipt (ADRs). A security issued by a U.S. bank in place of the foreign shares held in trust by that bank, thereby facilitating the trading of foreign shares in U.S. markets.

**Advisory Board:** A group of external advisors to a private equity group or portfolio company. Advice provided varies from overall strategy to portfolio valuation. Less formal than a Board of Directors.

**Allocation:** The amount of securities assigned to an investor, broker, or underwriter in an offering. An allocation can be equal to or less than the amount indicated by the investor during the subscription process, depending on market demand for the securities.

**Amortization:** An accounting procedure that gradually reduces the book value of an intangible asset through periodic charges to income.

**AMT:** Alternative Minimum Tax. A tax designed to prevent wealthy investors from using tax shelters to avoid income tax. The calculation of the AMT takes into account tax-preference items.

**Angel Financing:** Capital raised for a private company from independently wealthy investors. This capital is generally used as seed financing.

**Angel Fund:** A formal or informal assemblage of active angel investors who cooperate in some part of the investment process. Key characteristics of an angel group are: control by member angels (who manage the entity or have control over the entity's managers), and collaboration by member angels in the investment process.

**Angel Investing:** An angel investor is an individual who makes direct investments of personal funds into a venture, typically early-stage businesses. Because the capital is being invested at a risky time in a business venture, the angel must be capable of taking a loss of the entire investment, and, as such, most angel investors are high-net-worth individuals. These individuals are nearly always "accredited investors" as defined under the Securities Act of 1933.

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- B -

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**Balance Sheet:** A condensed financial statement showing the nature and amount of a company's assets, liabilities, and capital on a given date.

**Bankruptcy:** An inability to pay debts. Chapter 11 of the bankruptcy code deals with reorganization, which allows the debtor to remain in business and negotiate for a restructuring of debt.

**Bear Hug:** An offer made directly to the Board of Directors of a target company. Usually made to increase the pressure on the target with the threat that a tender offer may follow.

**Best Efforts:** An offering in which the investment banker agrees to distribute as much of the offering as possible and return any unsold shares to the issuer.

**Blue Sky Laws:** A common term that refers to laws passed by various states to protect the public against securities fraud. The term originated when a judge ruled that a stock had as much value as a patch of blue sky.

**Book Value:** Book value of a stock is determined from a company's balance sheet by adding all current and fixed assets and then deducting all debts, other liabilities, and the liquidation price of any preferred issues. The sum arrived at is divided by the number of common shares outstanding, and the result is book value per common share.

**Bond:** Specific type of debt instrument most commonly sold by government entities.

**Bridge Financing:** A limited amount of equity or short-term debt financing typically raised within 6-18 months of an anticipated public offering or private placement meant to “bridge” a company to the next round of financing.

**Burn Out / Cram Down:** Extraordinary dilution, by reason of a round of financing, of a non-participating investor's percentage ownership in the issuer.

**Burn Rate:** The rate at which a company expends net cash over a certain period, usually a month.

**Business Development Company (BDC):** A vehicle established by Congress to allow smaller, retail investors to participate in and benefit from investing in small private businesses as well as the revitalization of larger private companies.

**Business Judgment Rule:** The legal principle that assumes the board of directors is acting in the best interests of the shareholders unless it can be clearly established that it is not. If the board was found to violate the business judgment rule, it would be in violation of its fiduciary duties to the shareholders.

**Business Plan:** A document that describes the entrepreneur's idea, the market problem, proposed solution, business and revenue models, marketing strategy, technology, company profile, competitive landscape, as well as financial data for coming years. The business plan opens with a brief executive summary, most probably the most important element of the document due to the time constraints of venture capital funds and angels.

- C -

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**CAGR:** Compound Annual Growth Rate. The year-over-year growth rate applied to an investment or other aspect of a firm using a base amount.

**Call Option:** The right to buy a security at a given price (or range) within a specific time period.

**Capital (or Assets) Under Management:** The amount of capital available to a fund-management team for venture investments.

**Capital Gains:** The difference between an asset's purchase price and selling price, when the selling price is greater. Long-term capital gains (on assets held for a year or longer) are taxed at a lower rate than ordinary income.

**Capitalization Table:** Also called a “Cap Table,” this is a table showing the total amount of the various securities issued by a firm. This typically includes the amount of investment obtained from each source and the securities distributed — e.g., common and preferred shares, options, warrants, etc. — and respective capitalization ratios.

**Capitalize:** To record an outlay as an asset (as opposed to an expense), which is subject to depreciation or amortization.

**Carried Interest or “Carry”:** The portion of any gains realized by the fund to which the fund managers are entitled, generally without having to contribute capital to the fund. Carried interest payments are customary in the venture capital industry, in order to create a significant economic incentive for venture capital fund managers to achieve capital gains.

**Cash Position:** The amount of cash available to a company at a given point in time.

**Chapter 11:** The part of the Bankruptcy Code that provides for reorganization of a bankrupt company’s assets.

**Chapter 7:** The part of the Bankruptcy Code that provides for liquidation of a company’s assets.

**Claim Dilution:** A reduction in the likelihood that one or more of the firm’s claimants will be fully repaid, including time value of money considerations.

**Clawback:** A clawback obligation represents the general partner’s promise that, over the life of the fund, the managers will not receive a greater share of the fund’s distributions than they bargained for. Generally, this means that the general partner may not keep distributions representing more than a specified percentage (e.g., 20%) of the fund’s cumulative profits, if any. When triggered, the clawback will require that the general partner return to the fund’s limited partners an amount equal to what is determined to be “excess” distributions.

**Closed-end Fund:** A type of fund that has a fixed number of shares outstanding, which are offered during an initial subscription period, similar to an initial public offering. After the subscription period is closed, the shares are traded on an exchange between investors, like a regular stock. The market price of a closed-end fund fluctuates in response to investor demand as well as changes in the values of its holdings or its Net Asset Value. Unlike open-end mutual funds, closed-end funds do not stand ready to issue and redeem shares on a continuous basis.

**Closing:** An investment event occurring after the required legal documents are implemented between the investor and a company and after the capital is transferred in exchange for company ownership or debt obligation.



**Co-investment:** The syndication of a private equity financing round or an investment by an individual (usually general partners) alongside a private equity fund in a financing round.

**Collar Agreement:** Agreed-upon adjustments in the number of shares offered in a stock-for-stock exchange to account for price fluctuations before the completion of the deal.

**Committed Capital:** The total dollar amount of capital pledged to a private equity fund.

**Common Stock:** A unit of ownership of a corporation. In the case of a public company, the stock is traded between investors on various exchanges. Owners of common stock are typically entitled to vote on the selection of directors and other important events and in some cases receive dividends on their holdings. Investors who purchase common stock hope that the stock price will increase so the value of their investment will appreciate. Common stock offers no performance guarantees. Additionally, in the event that a corporation is liquidated, the claims of secured and unsecured creditors and owners of bonds and preferred stock take precedence over the claims of those who own common stock.

**Conversion Ratio:** The number of shares of stock into which a convertible security may be converted. The conversion ratio equals the par value of the convertible security divided by the conversion price.

**Convertible Security:** A bond, debenture or preferred stock that is exchangeable for another type of security (usually common stock) at a pre-stated price. Convertibles are appropriate for investors who want higher income, or liquidation-preference protection, than is available from common stock, together with greater appreciation potential than regular bonds offer. (See Common Stock, Dilution, and Preferred Stock).

**Convertible [Note] [Debenture]:** Debt instrument that automatically or voluntarily converts to some other security, either debt or equity.

**Convertible Preferred Stock:** Preferred stock that may be converted into common stock or another class of preferred stock, either voluntarily or mandatory.

**Corporate Charter:** The document prepared when a corporation is formed. The Charter sets forth the objectives and goals of the corporation, as well as a complete statement of what the corporation can and cannot do while pursuing these goals.

**Corporate Resolution:** A document stating that the corporation's board of directors has authorized a particular individual to act on behalf of the corporation.

**Corporate Venturing:** Venture capital provided by [in-house investment funds of] large corporations to further their own strategic interests.

**Corporation:** A legal, taxable entity chartered by a state or the federal government. Ownership of a corporation is held by the stockholders.

**Covenant:** A protective clause in an agreement.

**Cumulative Preferred Stock:** A stock having a provision that if one or more dividend payments are omitted, the omitted dividends (arrearage) must be paid before dividends may be paid on the company's common stock.

**Cumulative Voting Rights:** When shareholders have the right to pool their votes to concentrate them on an election of one or more directors rather than apply their votes to the election of all directors. For example, if the company has 12 openings to the Board of Directors, in statutory voting, a shareholder with 10 shares casts 10 votes for each opening ( $10 \times 12 = 120$  votes). Under the cumulative voting method however, the shareholder may opt to cast all 120 votes for one nominee (or any other distribution he might choose).

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- D -

**Debenture:** A debt instrument; basically the same as a Promissory Note.

**Debt:** Any obligation by one person to pay another. May be a primary (direct) obligation as in a Note, or a secondary (contingent) obligation as in a guaranty.

**Debt Instrument:** Any instrument evidencing the obligation of the maker to pay the holder of the debt instrument. Includes Bonds, Debentures and Notes of all kinds.

**Deficiency Letter:** A letter sent by the SEC to the issuer of a new issue regarding omissions of material fact in the registration statement.

**Demand Registration:** Resale registration that gives the investor the right to require the Company to file a Registration Statement registering the resale of the securities issued to the investor in a private offering.

**Demand Rights:** Contemplate that the company must initiate and pursue the registration of a public offering including, although not necessarily limited to, the shares proffered by the requesting shareholder(s).

**Depreciation:** An expense recorded to reduce the value of a long-term tangible asset. Since it is a non-cash expense, it increases free cash flow while decreasing the amount of a company's reported earnings.

**Dilution:** A reduction in the percentage ownership of a given shareholder in a company caused by the issuance of new shares.

**Dilution Protection:** Mainly applies to convertible securities. Standard provision whereby the conversion ratio is changed accordingly in the case of a stock dividend or extraordinary distribution to avoid dilution of a convertible bondholder's potential equity position. Adjustment usually requires a split or stock dividend in excess of 5% or issuance of stock below book value. Share Purchase Agreements also typically contain anti-dilution provisions to protect investors in the event that a future round of financing occurs at a valuation that is below the valuation of the current round.

**Director:** Person elected by shareholders to serve on the board of directors. The directors appoint the president, vice president and all other operating officers, and decide when dividends should be paid (among other matters).

**Disclosure Document:** A booklet outlining the risk factors associated with an investment.

**Diversification:** The process of spreading investments among various types of securities and various companies in different fields.

**Dividend:** The payments designated by the Board of Directors to be distributed pro-rata among the shares outstanding. On preferred shares, it is generally a fixed amount. On common shares, the dividend varies with the fortune of the company and the amount of cash on hand and may be omitted if business is poor or if the Directors determine to withhold earnings to invest in capital expenditures or research and development.

**Drag-Along Rights:** A majority shareholders' right, obligating shareholders whose shares are bound into the shareholders' agreement to sell their shares into an offer the majority wishes to execute.

**Due Diligence:** A process undertaken by potential investors — individuals or institutions — to analyze and assess the desirability, value, and potential of an investment opportunity.

- E -

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**Early Stage:** A state of a company that typically has completed its seed stage and has a founding or core senior management team, has proven its concept or completed its beta test, has minimal revenues, and no positive earnings or cash flows.

**EBITDA:** Earnings Before Interest, Taxes, Depreciation, and Amortization. A measure of cash flow calculated as:  
= Revenue - Expenses (excluding tax, interest, depreciation, and amortization).

EBITDA looks at the cash flow of a company. By not including interest, taxes, depreciation, and amortization, we can clearly see the amount of money a company brings in.

This is especially useful when one company is considering a takeover of another because the EBITDA would cover any loan payments needed to finance the takeover.

**Economies of Scale:** Economic principle that, as the volume of production increases, the cost of producing each unit decreases.

**Elevator Pitch:** An extremely concise presentation of an entrepreneur's idea, business model, company solution, marketing strategy, and competition delivered to potential investors. Should not last more than a few minutes, or the duration of an elevator ride.

**Employee Stock Option Plan (ESOP):** A plan established by a company whereby a certain number of shares is reserved for purchase and issuance to key employees. Such shares usually vest over a certain period of time to serve as an incentive for employees to build long-term value for the company.

**Employee Stock Ownership Plan:** A trust fund established by a company to purchase stock on behalf of employees.

**Equity:** Ownership in the capital of a Company. In corporations, it is called "stock"; in limited partnerships or LLCs, it is called "interests" or "units."

**Equity Kicker:** Option for private equity investors to purchase shares at a discount. Typically associated with mezzanine financings where a small number of shares or warrants are added to what is primarily a debt financing.

**ERISA:** ERISA shall mean the United States Employee Retirement Income Security Act of 1974, as amended, including the regulations promulgated thereunder.

**ERISA Significant Participation Test:** A test that is satisfied if the General Partner determines in its reasonable discretion that Persons that are “benefit plan investors” within the meaning of Section (f)(2) of the Final Regulation constitute or are expected to constitute at least 25 percent of the interests of the Limited Partners.

Note that the test is 25% of the interests of all the limited partners, which means 20% (+/-) in the partnership as a whole, taking into account the general partner’s interest.

**Exchange Act:** [“34 Act”] Regulates periodic reporting by companies with publicly traded securities, companies with more than 500 shareholders, and brokers and dealers in securities.

**Exercise price:** The price at which an option or warrant can be exercised.

**Exit Strategy:** A fund’s intended method for liquidating its holdings while achieving the maximum possible return. These strategies depend on the exit climates, including market conditions and industry trends. Exit strategies can include selling or distributing the portfolio company’s shares after an initial public offering (IPO), a sale of the portfolio company, or a recapitalization.

- F -

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**Final Regulation:** An ERISA term, it is the United States Department of Labor’s Final Regulation relating to the definition of “plan assets” in (29 C.F.R. §2510.3-101).

**Finder:** A person who helps to arrange a transaction.

**Flipping:** The act of buying shares in an IPO and selling them immediately for a profit. Brokerage firms underwriting new stock issues tend to discourage flipping and will often try to allocate shares to investors who intend to hold on to the shares for some time. However, the temptation to flip a new issue once it has risen in price sharply is too irresistible for many investors who have been allocated shares in a hot issue.

**Form 10-K:** This is the annual report that most reporting companies file with the Commission. It provides a comprehensive overview of the registrant’s business.

**Form 10-KSB:** This is the annual report filed by reporting “small business issuers.” It provides a comprehensive overview of the company’s business, although its requirements call for slightly less detailed information than required by Form 10-K.

**Form S-1:** The form can be used to register securities for which no other form is authorized or prescribed, except securities of foreign governments or political sub-divisions thereof.

**Form S-4:** Type of Registration Statement under which public company mergers and security exchange offers may be registered with the SEC.

**Form SB-2:** This form may be used by “small business issuers” to register securities to be sold for cash. This form requires less detailed information about the issuer’s business than Form S-1.

**Founders’ Shares:** Shares owned by a company’s founders upon its establishment.

**Free cash flow:** The cash flow of a company available to service the capital structure of the firm. Typically measured as operating cash flow less capital expenditures and tax obligations.

**Full Ratchet Antidilution:** The sale of a single share at a price less than the favored investors paid reduces the conversion price of the favored investors’ convertible preferred stock “to the penny.” For example, from \$1.00 to 50 cents, regardless of the number of lower-priced shares sold.

**Fully Diluted Earnings Per Share:** Earnings per share expressed as if all outstanding convertible securities and warrants have been exercised.

**Fully Diluted Outstanding Shares:** The number of shares representing total company ownership, including common shares and current conversion or exercised value of the preferred shares, options, warrants, and other convertible securities.

**Fund Size:** The total amount of capital committed by the investors of a venture capital fund.

## - G -

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**GAAP:** Generally Accepted Accounting Principles. The common set of accounting principles, standards, and procedures. GAAP is a combination of authoritative standards set by standard-setting bodies as well as accepted ways of doing accounting.

**General Partner (GP):** The partner in a limited partnership responsible for all management decisions of the partnership. The GP has a fiduciary responsibility to act for the benefit of the limited partners (LPs) and is fully liable for its actions.

**Golden Handcuffs:** This occurs when an employee is required to relinquish unvested stock when terminating his employment contract early.

**Golden Parachute:** Employment contract of upper management that provides a large payout upon the occurrence of certain control transactions, such as a certain percentage share purchase by an outside entity or when there is a tender offer for a certain percentage of a company's shares. This is discussed in more detail at the Executive Employment Agreement.

## - H -

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**Holding Company:** A corporation that owns the securities of another, in most cases with voting control.

**Holding Period:** The amount of time an investor has held an investment. The period begins on the date of purchase and ends on the date of sale, and determines whether a gain or loss is considered short term or long term, for capital-gains-tax purposes.

**Hot Issue:** A newly issued stock that is in great public demand. Technically, it is when the secondary market price on the effective date is above the new issue offering price. Hot issues usually experience a dramatic rise in price at their initial public offering because the market demand outweighs the supply.

**Hurdle Rate:** The internal rate of return that a fund must achieve before its general partners or managers may receive an increased interest in the proceeds of the fund. Often, if the expected rate of return on an investment is below the hurdle rate, the project is not undertaken.

**Initial Public Offering (IPO):** The sale or distribution of a stock of a portfolio company to the public for the first time. IPOs are often an opportunity for the existing investors (often venture capitalists) to receive significant returns on their original investment. During periods of market downturns or corrections, the opposite is true.

**Institutional Investors:** Organizations that professionally invest, including insurance companies, depository institutions, pension funds, investment companies, mutual funds, and endowment funds.

**Investment Company Act of 1940:** Investment Company Act shall mean the Investment Company Act of 1940, as amended, including the rules and regulations promulgated thereunder.

**Investment Letter:** A letter signed by an investor purchasing unregistered long securities under Regulation D, in which the investor attests to the long-term investment nature of the purchase. These securities must be held for a minimum of one year before they can be sold.

**IRA Rollover:** The reinvestment of assets received as a lump-sum distribution from a qualified tax-deferred retirement plan. Reinvestment may be the entire lump sum or a portion thereof. If reinvestment is done within 60 days, there are no tax consequences.

**IRR:** Internal Rate of Return. A typical measure of how VC Funds measure performance. IRR is technically a discount rate: the rate at which the present value of a series of investments is equal to the present value of the returns on those investments.

**Issued Shares:** The amount of common shares that a corporation has sold (issued).

**Issuer:** Refers to the organization issuing or proposing to issue a security.



- K -

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**Kentucky Windage:** In hunting, the modified aim required to compensate for wind or target movement. Used herein to describe the process by which an investor must increase the percentage he needs today so that he will end up with a desired target percentage ownership in the future, after adjusting for future dilutive financing rounds.

**Key Employees:** Professional management attracted by the founder to run the company. Key employees are typically retained with warrants and ownership of the company.

- L -

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**Later Stage:** A stage of company growth characterized by viable products, a developed market, significant customers, sustained revenue growth, and both profits and positive cash flow from operations. Later-stage companies would generally be candidates for an IPO. Investments in the C round or after qualify as later stage.

**Lead Investor:** Also known as a bell cow investor. Member of a syndicate of private equity investors holding the largest stake, in charge of arranging the financing and most actively involved in the overall project.

**Leveraged Buyout (LBO):** A takeover of a company, using a combination of equity and borrowed funds. Generally, the target company's assets act as the collateral for the loans taken out by the acquiring group. The acquiring group then repays the loan from the cash flow of the acquired company. For example, a group of investors may borrow funds, using the assets of the company as collateral, in order to take over a company. Or the management of the company may use this vehicle as a means to regain control of the company by converting a company from public to private. In most LBOs, public shareholders receive a premium to the market price of the shares.

**Limited Partner (LP):** An investor in a limited partnership who has no voice in the management of the partnership. LPs have limited liability and usually have priority over GPs upon liquidation of the partnership.

**Limited Partnerships:** An organization comprised of a general partner, who manages a fund, and limited partners, who invest money but have limited liability and are not involved with the day-to-day management of the fund. In the typical venture capital fund, the general partner receives a management fee and a percentage of the profits (or carried interest). The limited partners receive income, capital gains, and tax benefits.

**Liquidation:** 1) The process of converting securities into cash. 2) The sale of the assets of a company to one or more acquirers in order to pay off debts. In the event that a corporation is liquidated, the claims of secured and unsecured creditors and owners of bonds and preferred stock take precedence over the claims of those who own common stock.

**Liquidity Event:** An event that allows a VC to realize a gain or loss on an investment. The ending of a private equity provider's involvement in a business venture with a view to realizing an internal return on investment. Most common exit routes include Initial Public Offerings [IPOs], buy backs, trade sales, and secondary buyouts. (See also: Exit Strategy.)

**Lock-up Period:** The period of time that certain stockholders have agreed to waive their right to sell their shares of a public company. Investment banks that underwrite initial public offerings generally insist upon lockups for a set period of time, typically 180 days from large shareholders (such as 1% ownership or more) in order to allow an orderly market to develop in the shares. The shareholders that are subject to lockup usually include the management and directors of the company, strategic partners, and such large investors. These shareholders have typically invested prior to the IPO at a significantly lower price to that offered to the public and therefore stand to gain considerable profits. If a shareholder attempts to sell shares that are subject to lockup during the lockup period, the transfer agent will not permit the sale to be completed.

- M -

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**Management Fee:** Compensation for the management of a venture fund's activities, paid from the fund to the general partner or investment advisor. This compensation generally includes an annual management fee.

**Management Team:** The persons who oversee the activities of a venture capital fund.

**Market Capitalization:** The total dollar value of all outstanding shares. Computed as shares multiplied by current price per share. Prior to an IPO, market capitalization is arrived at by estimating a company's future growth and by comparing a company with similar public or private corporations. (See also: Pre-Money Valuation.)

**Merger:** Combination of two or more corporations in which greater efficiency is supposed to be achieved by the elimination of duplicate plant, equipment, and staff, and the reallocation of capital assets to increase sales and profits in the enlarged company.

**Mezzanine Financing:** Refers to the stage of venture financing for a company immediately prior to its IPO. Investors entering in this round have lower risk of loss than those investors who have invested in an earlier round. Mezzanine-level financing can take the structure of preferred stock, convertible bonds, or subordinated debt.

**Mutual Fund:** A mutual fund, or an open-end fund, sells as many shares as investor demand requires. As money flows in, the fund grows. If money flows out of the fund, the number of the fund's outstanding shares drops. Open-end funds are sometimes closed to new investors, but existing investors can still continue to invest money in the fund. In order to sell shares, an investor usually sells the shares back to the fund. If an investor wishes to buy additional shares in a mutual fund, the investor must buy newly issued shares directly from the fund. (See also: Closed-end Funds.)

- N -

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**NASD:** The National Association of Securities Dealers. A mandatory association of brokers and dealers in the over-the-counter securities business. Created by the Maloney Act of 1938, an amendment to the Securities Act of 1934.

**NASDAQ:** An automated information network which provides brokers and dealers with price quotations on securities traded over the counter.

**Net Asset Value (NAV):** NAV is calculated by adding the value of all of the investments in the fund and dividing by the number of shares of the fund that are outstanding. NAV calculations are required for all mutual funds (or open-end funds) and closed-end funds. The price per share of a closed-end fund will trade at either a premium or a discount to the NAV of that fund, based on market demand. Closed-end funds generally trade at a discount to NAV.

**Net Financing Cost:** Also called the cost of carry or, simply, carry, the difference between the cost of financing the purchase of an asset and the asset's cash yield. Positive carry means that the yield earned is greater than the financing cost; negative carry means that the financing cost exceeds the yield earned.

**Net income:** The net earnings of a corporation after deducting all costs of selling, depreciation, interest expense, and taxes.

**Net Present Value:** An approach used in capital budgeting where the present value of cash inflow is subtracted from the present value of cash outflows. NPV compares the value of a dollar today versus the value of that same dollar in the future after taking inflation and return into account.

**New Issue:** A stock or bond offered to the public for the first time. New issues may be initial public offerings by previously private companies or additional stock or bond issues by companies already public. New public offerings are registered with the Securities and Exchange Commission. (See Securities and Exchange Commission and Registration.)

**Newco:** The typical label for any newly organized company, particularly in the context of a leveraged buyout.

**No Shop, No Solicitation Clauses:** A no shop, no solicitation, or exclusivity, clause requires the company to negotiate exclusively with the investor, and not solicit an investment proposal from anyone else for a set period of time after the term sheet is signed. The key provision is the length of time set for the exclusivity period.

**Nonaccredited:** An investor not considered accredited for a Regulation D offering. (See “Accredited Investor.”)

**NYSE:** The New York Stock Exchange. Founded in 1792, the largest organized securities market in the United States. The Exchange itself does not buy, sell, own, or set prices of stocks traded there. The prices are determined by public supply and demand. Also known as the Big Board.

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**Offering Documents:** Documents evidencing a private-placement transaction. Include some combination of a purchase agreement and/or subscription agreement, notes or stock certificates, warrants, registration-rights agreement, stockholder or investment agreement, investor questionnaire, and other documents required by the particular deal.

**Open-end Fund:** An open-end fund, or a mutual fund, generally sells as many shares as investor demand requires. As money flows in, the fund grows. If money flows out of the fund, the number of the fund's outstanding shares drops. Open-end funds are sometimes closed to new investors, but existing investors can still continue to invest money in the fund. In order to sell shares, an investor generally sells the shares back to the fund. If an investor wishes to buy additional shares in a mutual fund, the investor generally buys newly issued shares directly from the fund.

**Option:** A security granting the holder the right to purchase a specified number of a Company's securities at a designated price at some point in the future. The term is generally used in connection with employee benefit plans as Incentive Stock Options (“ISOs” or “statutory options”) and Non-qualified stock options (“NSOs” or “Nonquals”). However “stand-alone options” may be issued outside of any plan. Generally non-transferable, in distinction to warrants.

**Option Pool:** The number of shares set aside for future issuance to employees of a private company.

**OTC:** Over-the-Counter. A market for securities made up of dealers who may or may not be members of a formal securities exchange. The over-the-counter market is conducted over the telephone and is a negotiated market rather than an auction market such as the NYSE.

**Outstanding Stock:** The amount of common shares of a corporation which are in the hands of investors. It is equal to the amount of issued shares less treasury stock.

**Oversubscription:** Occurs when demand for shares exceeds the supply or number of shares offered for sale. As a result, the underwriters or investment bankers must allocate the shares among investors. In private placements, this occurs when a deal is in great demand because of the company's growth prospects.

**Oversubscription Privilege:** In a rights issue, arrangement by which shareholders are given the right to apply for any shares that are not purchased.

- P -

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**Pari Passu:** At an equal rate or pace, without preference.

**Participating Preferred:** A preferred stock in which the holder is entitled to the stated dividend and also to additional dividends on a specified basis upon payment of dividends to the common stockholders.

**Participating Preferred Stock:** Preferred stock that has the right to share on a pro-rata basis with any distributions to the common stock upon liquidation, after already receiving the preferred-liquidation preference.

**Partnership:** A nontaxable entity in which each partner shares in the profits, losses, and liabilities of the partnership. Each partner is responsible for the taxes on its share of profits and losses.

**Partnership Agreement:** The contract that specifies the compensation and conditions governing the relationship between investors (LPs) and the venture capitalists (GPs) for the duration of a private equity fund's life.

**Penny Stocks:** Low-priced issues, often highly speculative, selling at less than \$5/share.

**Piggyback Registration:** A situation when a securities underwriter allows existing holdings of shares in a corporation to be sold in combination with an offering of new public shares.

**PIK Debt Securities:** (Payment in Kind) PIK Debt are bonds that may pay bondholders compensation in a form other than cash.

**PIPE:** [“Private Investment for Public Equity”] Private offering followed by a resale registration.

**PIV:** Pooled Investment Vehicle. A legal entity that pools various investors’ capital and deploys it according to a specific investment strategy.

**Placement Agent:** The investment bank, broker, or other person that locates investors to purchase securities from the Company in a private offering, in exchange for a commission.

**Plain English Handbook:** The Securities and Exchange Commission online version of “Plain English Handbook: How to Create Clear SEC Disclosure Documents.”

**Poison Pill:** A right issued by a corporation as a preventative to a takeover measure. It allows right holders to purchase shares in either their company or in the combined target and bidder entity at a substantial discount, usually 50%. This discount may make the takeover prohibitively expensive.

**Portfolio Companies:** Companies in which a given fund has invested.

**Post-Money Valuation:** The valuation of a company immediately after the most recent round of financing. This value is calculated by multiplying the company's total number of shares by the share price of the latest financing.

**Pre-Money Valuation:** The valuation of a company prior to a round of investment. This amount is determined by using various calculation models, such as discounted P/E ratios multiplied by periodic earnings or a multiple times a future cash flow discounted to a present cash value and a comparative analysis to comparable public and private companies.

**Preemptive Right:** A shareholder's right to acquire an amount of shares in a future offering at current prices per share paid by new investors, whereby his/her percentage ownership remains the same as before the offering.

**Preferred Dividend:** A dividend ordinarily accruing on preferred shares payable where declared and superior in right of payment to common dividends.

**Preferred Stock:** A class of capital stock that may pay dividends at a specified rate and that has priority over common stock in the payment of dividends and the liquidation of assets. Many venture capital investments use preferred stock as their investment vehicle. This preferred stock is convertible into common stock at the time of an IPO.

**Private Equity:** Equity securities of companies that have not “gone public” (are not listed on a public exchange). Private equities are generally illiquid and thought of as a long-term investment. As they are not listed on an exchange, any investor wishing to sell securities in private companies must find a buyer in the absence of a marketplace. In addition, there are many transfer restrictions on private securities. Investors in private securities generally receive their return through one of three ways: an initial public offering, a sale or merger, or a recapitalization.

**Private Offering/Private Placement:** Sale of unregistered, restricted securities by the company.

**Private Placement:** Also known as a Reg. D offering. The sale of a security directly to a limited number of investors in a private transaction.

**Private Placement Memorandum:** Also known as an Offering Memorandum. A document that outlines the terms of securities to be offered in a private placement. Resembles a business plan in content and structure.

**Private Securities:** Private securities are securities that are not registered and do not trade on an exchange. The price per share is set through negotiation between the buyer and the seller or issuer.

**Promissory Note:** [“Note”] Debt instrument in which the maker promises to pay the holder according to its terms.

**Prospectus:** A formal written offer to sell securities that provides an investor with the necessary information to make an informed decision. A prospectus explains a proposed or existing business enterprise and must disclose any material risks and information according to the securities laws. A prospectus must be filed with the SEC and be given to all potential investors. Companies offering securities, mutual funds, and offerings of other investment companies including Business Development Companies are required to issue prospectuses describing their history, investment philosophy or objectives, risk factors, and financial statements. Investors should carefully read them prior to investing.

**Public Company:** A company that has securities that have been sold in a registered offering and that are traded on a stock exchange or NASDAQ. Must be a Reporting Company under SEC rules. Often used incorrectly to describe companies that are only Reporting Companies and that have not conducted a registered offering under Securities Act.

**Put option:** The right to sell a security at a given price (or range) within a given time period.

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- Q -

**QPAM:** Qualified professional asset manager as defined by ERISA.

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- R -

**Recapitalization:** The reorganization of a company's capital structure. A company may seek to save on taxes by replacing preferred stock with bonds in order to gain interest deductibility. Recapitalization can be an alternative exit strategy for venture capitalists and leveraged-buyout sponsors. (See also: Exit Strategy and Leveraged Buyout.)

**Reconfirmation:** The act a broker/dealer makes with an investor to confirm a transaction.

**Red Herring:** The common name for a preliminary prospectus, due to the red SEC required legend on the cover. (See also: Prospectus.)

**Redeemable Preferred Stock:** Redeemable preferred stock, also known as exploding preferred, at the holder's option after (typically) five years, which in turn gives the holders (potentially converting to creditors) leverage to induce the company to arrange a liquidity event. The threat of creditor status can move the founders off the dime if a liquidity event is not occurring with sufficient rapidity.

**Registered Offering:** ["Public Offering"] A transaction in which a Company sells specified securities to the public under a Registration Statement which has been declared effective by the SEC.

**Registration:** The SEC's review process of all securities intended to be sold to the public. The SEC requires that a registration statement be filed in conjunction with any public securities offering. This document includes operational and financial information about the company, the management, and the purpose of the offering. The registration statement and the prospectus are often referred to interchangeably. Technically, the SEC does not "approve" the disclosures in prospectuses.



**Registration Obligation:** The obligation of Company to register the shares issued to an investor in a private offering for resale to the public through a Registration Statement which the SEC has declared effective.

**Registration Rights:** The right to require that a company register restricted shares. Demand Registered Rights enable the shareholder to request registration at any time, while Piggy Back Registration Rights enable the shareholder to request that the company register his or her shares when the company files a registration statement (for a public offering with the SEC).

**Registration Rights Agreement:** Separate agreement in which the investor's registration rights are evidenced.

**Registration Statement:** The document filed by a Company with the SEC under the Securities Act in order to obtain approval to sell the securities described in the Registration Statement to the public. [S-1, S-2, S-3, S-4, SB-1, SB-2, S-8, etc.] Includes the Prospectus.

**Regulation A:** SEC provision for simplified registration for small issues of securities. A Reg. A issue may require a shorter prospectus and carries lesser liability for directors and officers for misleading statements.

**Regulation C:** The regulation that outlines registration requirements for Securities Act of 1933.

**Regulation D:** Regulation D is the rule (Reg. D is a "regulation" comprising a series of "rules") that allow for the issuance and sale of securities.

**Regulation D Offering:** (See Private Placement.)

**Regulation S:** The rules relating to Offers and Sales made outside the US without SEC Registration.

**Regulation S-B:** Reg. S-B of the Securities Act of 1933 governs the Integrated Disclosure System for Small Business Issuers.

**Regulation S-K:** The Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934, and Energy Policy and Conservation Act of 1975.

**Regulation S-X:** The regulation that governs the requirements for financial statements under the Securities Act of 1933 and the Securities Exchange Act of 1934.

**Reporting Company:** A company that is registered with the SEC under the Exchange Act.

**Resale Registration:** Registration by a Company of the investor's sale of the shares purchased by the investor in a private offering.

**Restricted Securities:** Public securities that are not freely tradable due to SEC regulations. (See also: Securities and Exchange Commission.)

**Restricted Shares:** Shares acquired in a private placement are considered restricted shares and may not be sold in a public offering absent registration or after an appropriate holding period has expired. Non-affiliates must wait one year after purchasing the shares, after which time they may sell less than 1% of their outstanding shares each quarter. For affiliates, there is a two-year holding period.

**Right of First Refusal:** The right of first refusal gives the holder the right to meet any other offer before the proposed contract is accepted.

**Rights Offering:** Issuance of "rights" to current shareholders allowing them to purchase additional shares, usually at a discount to market price. Shareholders who do not exercise these rights are usually diluted by the offering. Rights are often transferable, allowing the holder to sell them on the open market to others who may wish to exercise them. Rights offerings are particularly common to closed-end funds, which cannot otherwise issue additional ordinary shares.

**Risk:** The chance of loss on an investment due to many factors, including inflation, interest rates, default, politics, foreign exchange, call provisions, etc. In Private Equity, risks are outlined in the Risk Factors section of the Placement Memorandum.

**Rule 144:** Rule 144 provides for the sale of restricted stock and control stock. Filing with the SEC is required prior to selling restricted and control stock, and the number of shares that may be sold is limited.

**Rule 144A:** A safe-harbor exemption from the registration requirements of Section 5 of the 1933 Act for resales of certain restricted securities to qualified institutional buyers, which are commonly referred to as “QIBs.” In particular, Rule 144A affords safe-harbor treatment for reoffers or resales to QIBs — by persons other than issuers — of securities of domestic and foreign issuers that are not listed on a U.S. securities exchange or quoted on a U.S. automated inter-dealer quotation system. Rule 144A provides that reoffers and resales in compliance with the rule are not “distributions” and that the reseller is therefore not an “underwriter” within the meaning of Section 2(a)(11) of the 1933 Act. If the reseller is not the issuer or a dealer, it can rely on the exemption provided by Section 4(1) of the 1933 Act. If the reseller is a dealer, it can rely on the exemption provided by Section 4(3) of the 1933 Act.

**Rule 144A Exchange Offer:** A transaction in which one class of securities that were issued in a private placement are exchanged for another, unusually almost identical, class of securities, in a transaction registered with the SEC on a Form S-4 Registration Statement.

**Rule 501:** Rule 501 of Regulation D defines Accredited Investor, among other definitions and regulations.

**Rule 505:** Rule 505 of Regulation D is an exemption for limited offers and sales of securities.

**Rule 506:** Rule 506 of Regulation D is considered a “safe harbor” for the private-offering exemption of Section 4(2) of the Securities Act of 1933. Companies using the Rule 506 exemption can raise an unlimited amount of money if they meet certain exemptions.

- S -

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**SBIR:** Small Business Innovation Research Program. See Small Business Innovation Development Act of 1982.

**Secondary Sale:** The sale of private or restricted holdings in a portfolio company to other investors.

**Securities:** Includes all types of equity and debt instruments and rights in and to them.

**Securities Act of 1933:** The federal law covering new issues of securities. It provides for full disclosure of pertinent information relating to the new issue and also contains antifraud provisions.

**Securities Act of 1934:** The federal law that established the Securities and Exchange Commission. The act outlaws misrepresentation, manipulation, and other abusive practices in the issuance of securities.

**Securities and Exchange Commission:** The SEC is an independent, nonpartisan, quasi-judicial regulatory agency that is responsible for administering the federal securities laws. These laws protect investors in securities markets and ensure that investors have access to all material information concerning publicly traded securities. Additionally, the SEC regulates firms that trade securities, people who provide investment advice, and investment companies.

**Seed Money:** The first round of capital for a start-up business. Seed money usually takes the structure of a loan or an investment in preferred stock or convertible bonds, although sometimes it is common stock. Seed money provides startup companies with the capital required for their initial development and growth. Angel investors and early-stage venture capital funds often provide seed money.

**Seed Stage Financing:** An initial state of a company's growth characterized by a founding management team, business-plan development, prototype development, and beta testing.

**Senior Securities:** Securities that have a preferential claim over common stock on a company's earnings and in the case of liquidation. Generally, preferred stock and bonds are considered senior securities.

**Series A Preferred Stock:** The first round of stock offered during the seed or early-stage round by a portfolio company to the venture investor or fund. This stock is convertible into common stock in certain cases such as an IPO or the sale of the company. Later rounds of preferred stock in a private company are called Series B, Series C, and so on.

**Shell Corporation:** A corporation with no assets and no business. Typically, shell corporations are designed for the purpose of going public and later acquiring existing businesses. Also known as Specified Purpose Acquisition Companies (SPACs).

**Small Business Administration (SBA):** Provides loans to small-business investment companies (SBICs) that supply venture capital and financing to small businesses.

**Small Business Innovation Development Act of 1982:** The Small Business Innovation Research (SBIR) program is a set-aside program for domestic small-business concerns to engage in Research/Research and Development (R/R&D) that has the potential for commercialization. The SBIR program was established under the Small Business Innovation Development Act of 1982, reauthorized until September 30, 2000 by the Small Business Research and Development Enhancement Act, and reauthorized again until September 30, 2008 by the Small Business Reauthorization Act of 2000.

**Staggered Board:** This is an anti-takeover measure in which the election of the directors is split in separate periods so that only a percentage (e.g., one-third) of the total number of directors come up for election in a given year. It is designed to make taking control of the board of directors more difficult.

**Statutory Voting:** A method of voting for members of the Board of Directors of a corporation. Under this method, a shareholder receives one vote for each share and may cast those votes for each of the directorships. For example: An individual owning 100 shares of stock of a corporation that is electing six directors could cast 100 votes for each of the six candidates. This method tends to favor the larger shareholders.

**Stock Options:** 1) The right to purchase or sell a stock at a specified price within a stated period. Options are a popular investment medium, offering an opportunity to hedge positions in other securities, to speculate on stocks with relatively little investment, and to capitalize on changes in the market value of options contracts themselves through a variety of options strategies. 2) A widely used form of employee incentive and compensation. The employee is given an option to purchase its shares at a certain price (at or below the market price at the time the option is granted) for a specified period of years.

**Strategic Investors:** Corporate or individual investors that add value to investments they make through industry and personal ties that can assist companies in raising additional capital as well as provide assistance in the marketing and sales process.

**Subscription Agreement:** The application submitted by an investor wishing to join a limited partnership. All prospective investors must be approved by the General Partner prior to admission as a partner.

**Subordinated [Note] [Debt]:** Debt which by its terms has no right to be paid until another debt holder is paid. Also referred to as "junior" debt.

**Syndicate:** Underwriters or broker/dealers who sell a security as a group.

- T -

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**Tag-Along Rights / Rights of Co-Sale:** A minority-shareholder protection affording the right to include their shares in any sale of control and at the offered price.

**Takedown Schedule:** A takedown schedule means the timing and size of the capital contributions from the limited partners of a venture fund.

**Tax-free reorganizations:** Types of business combinations in which shareholders do not incur tax liabilities. There are four types — A, B, C, and D reorganizations. They differ in various ways in the amount of stock/cash that can be offered.

**Tender offer:** An offer to purchase stock made directly to the shareholders. One of the more common ways hostile takeovers are implemented.

**Term Sheet:** A summary of the terms the investor is prepared to accept. A non-binding outline of the principal points which the Stock Purchase Agreement and related agreements will cover in detail.

**Time Value of Money:** The basic principle that money can earn interest; therefore, something that is worth \$1 today will be worth more in the future if invested. This is also referred to as future value.

**Treasury Stock:** Stock issued by a company but later reacquired. It may be held in the company's treasury indefinitely, reissued to the public, or retired. Treasury stock receives no dividends and does not carry voting power while held by the company.

**Trust Indenture:** Agreement between the Company, the debt holders, and the trustee for the debt holders. Required for registered offerings of debt securities. (See Trust Indenture Act of 1939.)

- U -

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**ULPA:** Uniform Limited Partnership Act, see also the RULPA, Revised Uniform Limited Partnership Act U.L.P.A. § 101 et seq. (1976), as amended in 1985 (R.U.L.P.A.).

**Underwriter:** In jargon, the “underwriters” are the investment banks selling the securities in an underwritten registered offering. But beware, under the Securities Act, the class of persons who are considered “underwriters” is far more expansive and problematic.

**Underwritten Offering:** Registered offering that is sold through a consortium of investment banks assembled by one or more lead investment banks.

**Unit Offering:** Private or public offering of securities in groups of more than one security. Most often a share of stock and warrant to purchase some number of shares of stock, but could be two shares of stock, a note and a share of stock, etc. Also used in some cases to refer to the sale of LP and LLC interests, since those interests are composed of more than one right.

- V -

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**Venture Capital Financing:** An investment in a startup business that is perceived to have excellent growth prospects but does not have access to capital markets. Type of financing sought by early-stage companies seeking to grow rapidly.

**Voting Right:** The common stockholders’ right to vote their stock in the affairs of the company. Preferred stock usually has the right to vote when preferred dividends are in default for a specified amount of time. The right to vote may be delegated by the stockholder to another person.

- W -

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**Warrant:** A type of security that entitles the holder to buy a proportionate amount of common stock or preferred stock at a specified price for a period of years. Warrants are usually issued together with a loan, a bond, or preferred stock and act as sweeteners, to enhance the marketability of the accompanying securities. They are also known as stock-purchase warrants and subscription warrants.

**Weighted Average Antidilution:** The investor's conversion price is reduced, and thus the number of common shares received on conversion increased, in the case of a down round; it takes into account both: (a) the reduced price and, (b) how many shares (or rights) are issued in the dilutive financing.

**Williams Act of 1968:** An amendment of the Securities and Exchange Act of 1934 that regulates tender offers and other takeover-related actions such as larger share purchases.

**Workout:** A negotiated agreement between the debtor and its creditors outside the bankruptcy process.

**Write-off:** The act of changing the value of an asset to an expense or a loss. A write-off is used to reduce or eliminate the value of an asset and reduce profits.

**Write-up/Write-down:** An upward or downward adjustment of the value of an asset for accounting and reporting purposes. These adjustments are estimates and tend to be subjective, although they are usually based on events affecting the investee company or its securities beneficially or detrimentally.



## APPENDIX 11

### INVESTOR- VS. COMPANY-FAVORABLE TERM SHEET (SAMPLE 1)

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*[Notes: Where appropriate, investor-favorable provisions in this Term Sheet are denoted "IF" and company-favorable provisions are denoted "CF." Where certain provisions in this Term Sheet call for a number, we have included a range, the endpoints of which represent investor-favorable or company-favorable terms, depending on the circumstances.]*

This Term Sheet dated \_\_\_\_\_, 200\_\_ outlines the terms and conditions of a proposed investment by [Investor Name]. ("Investor") and the other investors listed on Exhibit A hereto (together with Investor, the "Investors") in [Company Name], a [State] corporation (the "Company"). This Term Sheet is an expression of intent only, and is not to be construed as a binding agreement, except for the "Exclusivity" and "Confidentiality" provisions contained herein.

#### OFFERING TERMS

**Issuer:** [Company Name], a [State] corporation.

**Amount of Financing:** A minimum of \$\_\_\_\_\_ and up to a maximum of \$\_\_\_\_\_, [including \$\_\_\_\_\_ received pursuant to outstanding bridge notes (the "Bridge Notes").

**Type of Security:** Series A Preferred Stock (the "Series A Preferred"), initially convertible on a 1:1 basis into shares of the Company's Common Stock (the "Common Stock").

**Price:** \$\_\_\_\_\_ per share (the "Original Purchase Price"). The Original Purchase Price represents a fully diluted pre-money valuation of \$\_\_\_\_\_ million.

**Investors:** Investor \$\_\_\_\_\_ shares

The other Investors listed on **Exhibit A** hereto \$\_\_\_\_\_ shares

[The Bridge Notes listed on **Exhibit B** hereto\*] \$\_\_\_\_\_ shares

[\* At the Closing, the outstanding principal of the Bridge Notes will automatically convert into shares of Series A Preferred at a conversion price equal to [75-100%] of the Original Purchase Price. All accrued interest, if any, will be paid at the Closing by the Company.]

**Anticipated Closing Date:** On or before \_\_\_\_\_, 200\_\_\_\_ (the “Closing”) [, with a subsequent closing to occur on or before [15-60] days following the Closing].

**Post-Closing Capitalization:** As set forth in the table attached as **Exhibit [B]** hereto. *[IF: The authorized but unissued shares of the Company as of the Closing shall not exceed by more than 5% the capitalization set forth on **Exhibit [B]**.]*

**Use of Proceeds:** Proceeds from the investment will be used for [working capital and general corporate purposes] and \_\_\_\_\_.  
*[IF: All other outstanding stockholder debt and deferred compensation will be converted into equity and reflected on the Company’s capitalization table, and hence considered paid-in capital, prior to the Closing.]*

## **TERMS OF SERIES A PREFERRED**

**Dividends:** The holders of the Series A Preferred shall be entitled to receive *[IF: cumulative] [CF: noncumulative]* dividends in preference to any dividend on the Common Stock at the rate of 8% of the Original Purchase Price per annum *[CF: when and as declared by the Board of Directors.]* The holders of the Series A Preferred also shall be entitled to participate pro rata in any dividends paid on the Common Stock on an as-converted-to-Common Stock basis.

**Liquidation Preference:** In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of the Common Stock a per-share amount equal to *[IF: \_\_\_\_\_ times]* the Original Purchase Price (as adjusted for any stock splits, dividends, and the like) plus any declared but unpaid dividends *[IF: and accrued interest thereon at a rate of [8%-10%] per annum]* (the “**Liquidation Preference**”). *[IF: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets of the Company shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on an as-converted-to-Common-Stock basis.] [IF: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets of the Company shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on an as-converted-to-Common-Stock basis until the holders of Series A Preferred have received an additional [two-four] times the Original Purchase Price per share; thereafter, the remaining assets of the Company shall be distributed to the holders of Common Stock.] [CF: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets of the Company shall be distributed ratably to the holders of the Common Stock until the holders of Common Stock shall have received a per-share amount equal to \$\_\_\_\_\_ per share (as adjusted for any stock splits, dividends, and the like); thereafter, the remaining assets of the Company shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on an as-converted-to-Common-Stock*

basis.] *[CF: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets of the Company shall be distributed ratably to the holders of the Common Stock.]* A merger, acquisition, or sale of voting control in which the stockholders of the Company immediately prior to the transaction do not own a majority of the outstanding shares of the surviving corporation or sale or lease of substantially all of the assets of the Company *[IF: or license of substantially all of the intellectual property of the Company]* shall be deemed to be a liquidation.

**Conversion:** The holders of the Series A Preferred shall have the right to convert the Series A Preferred, at the option of the holder, at any time, into shares of Common Stock. The initial conversion rate shall be one share of Series A Preferred into one share of Common Stock, subject to adjustment as provided below.

**Automatic Conversion:** The Series A Preferred shall be automatically converted into Common Stock, at the then-applicable conversion price, (i) in the event that the holders of at least *[IF: 66 2/3%]* *[CF: a majority]* of the outstanding Series A Preferred consent to such conversion or (ii) upon the closing of a firmly underwritten public offering of shares of Common Stock at a per-share price not less than [3-5] times the Original Purchase Price (as adjusted for stock splits, dividends and the like) per share and for a total offering of not less than [\$15-35] million (*[IF: after]* *[CF: before]* deduction of underwriters' commissions and expenses) (a "Qualified IPO").

**Antidilution Provisions:** The conversion price of the Series A Preferred will be subject to a *[IF: full ratchet]* *[IF: narrow-based weighted average]* *[CF: broad-based weighted average]* adjustment to reduce dilution in the event that the Company issues additional equity securities at a purchase price less than the applicable conversion price. The conversion price of the Series A Preferred will not be adjusted for the following issuances: (i) shares of Common Stock issued upon conversion of or as a dividend or distribution on the Series A Preferred, (ii) *[IF: no more than \_\_\_\_\_ shares of restricted stock or stock options granted to officers, directors, employees, or consultants as approved by the Company's Board of Directors]* *[IF: including the Series A Director(s) (as defined below)]*, (iii) shares of Common Stock subject to outstanding options, warrants or convertible securities as of the date hereof, (iv) the issuance of Common Stock or rights to purchase Common Stock issued in connection with equipment lease financing arrangements, credit agreements, debt financings, or other commercial transactions approved by the Board of Directors *[IF: including the Series A Director(s)]*, (v) shares of Common Stock or rights to purchase Common Stock issued for consideration other than cash pursuant to a merger, consolidation, acquisition or similar business combination approved by the Board of Directors *[IF: including the Series A Director(s)]*. *[The Series A Preferred will contain a "pay-to-play" feature whereby in the event of a dilutive issuance after the Closing, each Investor must purchase its full pro-rata share of such issuance in order to maintain its antidilution protection.]* The conversion price will also be subject to proportional adjustment for stock splits, stock dividends, recapitalizations, and the like.

## Redemption at Option

**of Investors:** At the election of the holders of at least *[IF: a majority]* *[CF: 66 2/3%]* of the Series A Preferred, the Company shall redeem the outstanding Series A Preferred *[IF: on or after \_\_\_\_\_, 200\_\_]* *[CF: in [three-seven] annual installments beginning on the [third-seventh] anniversary of the Closing]*. Such redemptions shall be at a purchase price equal to one hundred percent of the Original Purchase Price *[IF: plus declared and unpaid dividends]*. *[IF: To the extent that the Company's available cash flow does not permit such redemption, the remainder shall be paid in the form of a one-year promissory note to each unredeemed holder of Series A Preferred bearing interest at a rate of [8-10%] per annum, and the holders of a majority of Series A Preferred shall be entitled to elect a majority of the Company's Board of Directors until all principal and interest owing under such notes is paid in full.]*

**Voting Rights:** The Series A Preferred will vote together with the Common Stock and not as a separate class except as specifically provided herein or as otherwise required by law. Each share of Series A Preferred shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such share of Series A Preferred.

**Board of Directors:** The size of the Company's Board of Directors shall be set at [three-five]. At the Closing, the Board shall initially be comprised of \_\_\_\_\_ ]  
[with the Mutual Director (as defined below) to be appointed after the Closing].

At each subsequent meeting for the election of directors, the holders of the Series A Preferred, voting as a separate class, shall be entitled to elect [one-two] members of the Company's Board of Directors (the **"Series A Directors"**), the holders of the Common Stock, voting as a separate class, shall be entitled to elect [two-three] members of the Company's Board of Directors, and the remaining director will be selected by a majority vote of the holders of the Series A Preferred and the Common Stock, voting together as a single class (the **"Mutual Director"**).

The Company will indemnify board members to the maximum extent permitted by applicable law. *[IF: The Company will carry directors & officers insurance with coverage as approved by the Company's Board of Directors.]*

The Board of Directors' meetings shall be held [monthly] [quarterly] until such time as the Board unanimously determines that [monthly] [quarterly] meetings are not required. The Company will reimburse directors for their customary and reasonable expenses in attending Board meetings.

*[IF: The Board of Directors will establish a Compensation Committee, if none exists, to recommend management compensation, the Company benefit plans, and general equity-incentive plans for approval by the Board. The Compensation Committee shall contain no more than three persons, at least one of whom shall be a Series A Director. All decisions regarding executive compensation and the Company's equity-incentive plans shall be made only by the Compensation Committee, acting unanimously.]*

**Protective Provisions:** The Company may not, without the consent of holders of at least *[IF: 66 2/3%]* *[CF: a majority]* of the Series A Preferred: (i) declare or pay any dividends or make any distributions upon any of its equity securities; (ii) purchase, redeem, or otherwise acquire any of the Company's equity securities (including warrants, options, and other rights to acquire equity securities) other than the repurchase of equity securities pursuant to existing agreements; (iii) liquidate or dissolve; (iv) merge or consolidate with another corporation in which the holders of the Company's voting equity securities immediately prior to the transactions own 50% or less of the voting securities of the surviving corporation; (v) sell, license, or dispose of all or substantially all of the Company's assets, technology or intellectual property; (vi) change the authorized number of directors; (vii) create any new class or series of shares having rights, preferences or privileges *[IF: on a parity with or]* senior to the Series A Preferred; (viii) amend or waive any provision of its Certificate of Incorporation or Bylaws *[CF: in a manner that alters or changes the voting or other powers, preferences, or other special rights or privileges of the Series A Preferred [so as to affect them adversely]]*; (ix) increase or decrease the authorized number of shares of Series A Preferred; (x) increase or decrease the authorized number of shares of Preferred Stock; (xi) increase or decrease the authorized number of shares of Common Stock; *[IF: (x) change the nature of its business; or (xi) authorize or incur any indebtedness in excess of \$\_\_\_\_\_].*

**Information Rights:** *[CF: Upon the request of such Investor,]* the Company shall deliver to each Investor *[CF: holding more than \_\_\_\_\_ shares of Registrable Securities]* audited annual financial statements no later than 120 days following the close of the fiscal year and unaudited quarterly financial statements no later than 45 days following the close of such period. *[CF: Upon the request of such Investor,]* the Company will also furnish such Investor with monthly financial statements no later than 30 days following the close of such period and will provide a copy of the Company's annual operating plan no later than 30 days prior to the beginning of the fiscal year. Such Investor shall also be entitled to standard inspection and visitation rights. These provisions shall terminate upon a *[IF: Qualified IPO]* *[CF: IPO]* *[CF: acquisition, merger, or consolidation of the Company.]*

**Registration Rights:** *Demand Rights.* If Investors holding more than [25-50%] of the outstanding shares of Series A Preferred, including Common Stock issued on conversion of Series A Preferred (collectively, “**Registrable Securities**”), request that the Company file a registration statement having an aggregate offering price to the public of not less than (\$5,000,000-\$10,000,000), the Company will use its *[CF: reasonable]* best efforts to cause such shares to be registered, provided, however, that the Company shall not be obligated to effect any such registration prior to the [second-fifth] anniversary of the Closing. *[CF: The Company shall have the right to delay such registration under certain circumstances for one period not in excess of 90 days in any 12-month period.]*

The Company shall not be obligated to effect more than [one-two] registrations under these demand-right provisions, and shall not be obligated to effect a registration (i) during the [120-180] day period commencing with the date of the Company’s initial public offering, or (ii) if it delivers notice to the holders of the Registrable Securities within 30 days of any registration request of its intent to file a registration statement for such initial public offering within 90 days.

*“Piggyback” Rights.* The Investors shall be entitled to “piggyback” registration rights on all registrations of the Company or on any demand registrations of any other investor subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions. *[IF: If the Investors are so limited, however, no party shall sell shares in such registration other than the Company or the Investor, if any, invoking a demand registration.] [IF: Unless the registration is with respect to the Company’s initial public offering, in which shares are sold only for the account of the Company, in no event shall the shares to be sold by the Investors be reduced below [20-40%] of the total amount of securities included in the registration.]* No stockholder of the Company shall be granted piggyback registration rights which would reduce the number of shares includable by the holders of the Registrable Securities in such registration without the consent of the holders of at least *[IF: 66 2/3%] [CF: a majority]* of the Registrable Securities.

*S-3 Rights.* *[CF: Upon initiation by Investors holding at least (10-30%) of the outstanding shares of Series A Preferred,]* Investors shall be entitled to *[IF: unlimited]* demand registrations on Form S-3 (if available to the Company), so long as such registered offerings are not less than [\$500,000-\$1,000,000]. *[CF: The Company shall be obligated to effect no more than [two-four] S-3 registrations in any 12-month period.]*

*Expenses.* The Company shall bear registration expenses (exclusive of underwriting discounts and commissions) of all such demands, piggy-backs and *[CF: up to [two-four] S-3 registrations (including fees and expenses [CF: up to [\$10,000-\$25,000]]* of one special counsel for the selling stockholders).

*Termination of Registration Rights.* The demand, piggyback, and S-3 registration rights shall terminate upon the earlier to occur of (i) [three-seven] years following the Company's [IF: Qualified IPO] [CF: IPO] or (ii) as to any Investor, at such time as such Investor could sell all of its Series A Preferred during any three-month period under Rule 144.

*Subsequent Registration Rights.* Following the Closing, the Company shall not grant any registration rights senior to [IF: or pari passu with] those of the Investors without the consent of the holders of [IF: 66 2/3%] [CF: a majority] of the Registrable Securities.

*Lock-Up Provision.* Each Investor agrees that it will not sell its shares for a specified period (not to exceed [120-180] days) following the effective date of the Company's IPO, provided that all officers, directors, and other [1-5%] stockholders are similarly bound.

*Other Provisions.* Other provisions shall be contained in the Investor Rights Agreement with respect to registration rights as are reasonable, including cross-indemnification, the period of time in which the Registration Statement shall be kept effective, and underwriting arrangements.

**Right of First Refusal:** In the event the Company proposes to offer equity securities to any person, each Investor [CF: holding more than \_\_\_\_\_ shares of Registrable Securities] shall have the right, based on its percentage equity ownership of [IF: Series A Preferred] [CF: Common Stock, measured on a fully-diluted basis] to purchase its pro rata portion of such shares, provided that such right shall terminate upon a [IF: Qualified IPO] [CF: IPO] [CF: acquisition, merger, or consolidation of the Company] and shall not apply to (i) shares of Common Stock issued upon conversion of or as a dividend or distribution on the Series A Preferred, (ii) no more than \_\_\_\_\_ shares of restricted stock or stock options granted to officers, directors, employees, advisors, or consultants as approved by the Company's Board of Directors [IF: including the Series A Director(s)], (iii) shares of Common Stock subject to outstanding options, warrants, or convertible securities as of the date hereof (iv) shares of Common Stock or rights to purchase Common Stock issued in connection with equipment lease financing arrangements, credit agreements, debt financings, or other commercial transactions unanimously approved by the Board of Directors [IF: including the Series A Director(s)], or (v) shares of Common Stock or rights to purchase Common Stock issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board of Directors [IF: including the Series A Director(s)]. [IF: Any securities not subscribed for by an Investor may be reallocated among the other Investors.]

**[IPO Participation Rights:]** *[IF: To the extent permitted by applicable law and SEC policy, the Investors shall have the right to purchase up to [5-15%] of the shares offered in the Company's IPO. To the extent such right is limited by applicable law or SEC policy, the Investors shall instead have the right to buy that number of shares equal to [5-15%] of the shares offered in the Company's IPO in a concurrent private placement.]*

**Purchase Agreement:** The investment shall be made pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the Investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company *[IF: and of the Founders (as defined below)]*, covenants of the Company reflecting the provisions set forth herein and appropriate conditions of closing, including satisfactory completion of financial and legal due diligence and an opinion of counsel for the Company.

**Qualified Small Business Stock:** The Company shall make representations satisfactory to the Investors that the Series A Preferred is "qualified small business stock" within the meaning of Section 1202 of the Internal Revenue Code of 1986, as amended. Additionally, the Company shall not perform any act that would alter this "qualified small business stock" designation without the consent of a majority of the Board of Directors.

**Management Rights Letter:** The Company shall execute a Management Rights Letter with each Investor in form and substance acceptable to such Investor.

## **EMPLOYEE MATTERS**

**Employee Pool:** The Company will reserve \_\_\_\_\_ shares of its Common Stock ([15-30%] of its fully diluted capital stock following the issuance of its Series A Preferred) for issuances to directors, officers, employees, and consultants, as set forth on **Exhibit [B]** hereto.

**Founder Vesting:** As of the Closing, the Common Stock held by the Founders ("**Founder Common Stock**") shall vest as follows: *[CF: [25-50%] will vest as of the Closing, with [50-75%] to vest [monthly] [quarterly] over the next [two-four] years. The Company shall have the option to repurchase all unvested Founder Common Stock at cost. [CF: Upon a termination without Cause (which shall include, but not be limited to, failure to perform duties to the satisfaction of the Board of Directors, malfeasance, death, disability, and other acts or omissions commonly included in the definition of Cause) an additional 12 months of the Founder Common Stock shall vest, provided that the same 12 months of otherwise vested Founder Common Stock shall be subject to repurchase by the Company in the event that the Founder voluntarily terminates his employment with the Company.]*



**Non-Founder Vesting:** Except as otherwise approved by the Investors, all Common Stock, options, and other stock equivalents issued to employees, directors, consultants, and other service providers will be subject to vesting as follows: [25-50%] to vest on the first anniversary of such issuance, with the remaining [50-75%] to vest [monthly] [quarterly] over the next three years. The Company shall have the option to repurchase all unvested shares at cost.

**Restrictions on Transfer:** *[IF: No transfers of unvested Common Stock shall be permitted.]* No transfers of Common Stock shall be permitted for a specified period (not to exceed [120-180] days) following the effective date of the Company's IPO. The Company's Bylaws shall contain a right of first refusal on all transfers of Common Stock, subject to customary exceptions. If the Company elects not to exercise such right, the Company shall assign such right to the Investors on a pro-rata basis *[IF: (with any shares not subscribed for by an Investor subject to reallocation among the other Investors)].*

**Proprietary Information and Inventions Agreements:** Prior to the Closing, the Company will enter into Proprietary Information and Inventions Agreements *[IF: in form and substance acceptable to the Investors]* with all officers, employees, and consultants, containing standard provisions with respect to confidentiality, corporate ownership of inventions and innovations, and noncompetition and nonsolicitation of employees and customers.

#### **Right of Refusal and**

**Co-Sale Agreement:** The shares of Common Stock held by \_\_\_\_\_ (the "Founders") shall be subject to restrictions on transfer and made subject to a right of first refusal and co-sale agreement (with the exceptions set forth below) with the Investors such that the Founders may not sell, transfer, or exchange their stock unless the Company first, and each of the Investors, second, has an opportunity to purchase such shares, which purchase with respect to the Investors shall be on a pro-rata basis *[IF: (provided that any shares not subscribed for by an Investor may be reallocated among the other Investors)]* and if such rights are not fully exercised, then each Investor has an opportunity to participate in the sale by a Founder to a third party on a pro-rata basis. These rights of first refusal and co-sale shall not apply to and shall terminate upon a *[IF: Qualified IPO] [CF: IPO] [CF: acquisition, merger, or consolidation of the Company.]*

These rights of first refusal and co-sale will not apply to (i) non-cash transfers to family members or trusts, (ii) a transfer or transfers to any affiliate or (iii) a transfer or transfers by any Founder which in the aggregate do not exceed [1-10%] of the shares of Common Stock owned by such Founder *[IF: on the date of the Closing] [CF: from time to time]*, provided in each case that the transferee agrees to abide by these provisions. The Investors and the Company will have similar rights to acquire shares which would otherwise be transferred involuntarily.

**[Drag-Along Rights:]** *[IF: So long as the Investors own Registrable Securities representing at least [25-50%] of the Common Stock on a fully-diluted basis, the Investors shall have the right, in the event of a proposed sale of the Company to a third party (whether structured as a merger, reorganization, as set sale or otherwise), to require the Founders to transfer in such sale all of the Company securities then held by them. Such rights will terminate upon a [IF: Qualified IPO]. [CF: IPO] [CF: acquisition, merger, or consolidation of the Company.]*

**Key Person Insurance:** Prior to the Closing, the Company will obtain a key person life insurance policy on \_\_\_\_\_, in the amount of \$\_\_\_\_\_, with the *[IF: Investors] [CF: Company]* as the beneficiary.

**[Executive Search:]** [The Company will use its best efforts to hire a [Chief Executive Officer] [Chief Financial Officer] acceptable to the Investors as soon as practicable following the Closing.]

**[Special Indemnification:]** *[IF: To the extent that the Company is required to issue additional shares that are committed, promised, or outstanding and that are not included in the capitalization reflected on **Exhibit [B]** hereto, the Founders will indemnify and hold harmless the [Company] [Investors] against such issuance and will agree to reduce their own share ownership to make up the difference.]*

## **OTHER MATTERS**

**Transfer of Rights:** Any rights accorded to the Investors may be transferred to (i) any partner or retired partner of any Investor which is a partnership, (ii) any member or former member of any Investor which is a limited-liability company, (iii) any family member or trust for the benefit of any individual Investor, (iv) any transferee who acquires at least \_\_\_\_\_ shares of Registrable Securities; or (v) any affiliated venture capital fund of an Investor; provided the Company is given written notice thereof.

### **Conditions Precedent:**

**to Financing:** With the exception of the “Exclusivity” and “Confidentiality” sections herein, this Term Sheet is not intended as a legally binding commitment of the parties, and any obligation on the part of the Investors is subject to the following conditions precedent:

1. Completion of legal documentation satisfactory to the Investors.
2. Satisfactory completion of due diligence by the Investors.
3. [Conversion of the Bridge Notes].

**Finders:** The Company and the Investors shall each indemnify the other for any broker's or finder's fees for which either is responsible.

**Legal Fees and Expenses:** Counsel to [Investor] [the Company] will draft documents. The Company will pay the reasonable fees and expenses of [lawyer], counsel to Investor *[CF: up to a maximum of \$20,000.]*

**Exclusivity:** In consideration of Investor's commitment to devote substantial resources to a due diligence review of the Company and preparation of legal documents relating to this transaction, the Company agrees that during the period between its execution of this Term Sheet and [30-90] days thereafter (or such earlier date that Investor advises the Company in writing that Investor is electing to discontinue efforts with respect to an investment in the Company), it will not and will not permit any of its officers, directors, or agents acting on its behalf to: (i) take any action to solicit, initiate, encourage, or assist the submission of any proposal, negotiation, or offer from any person or entity other than Investor or the other Investors relating to the acquisition, sale, or transfer of any of the capital stock of the Company or the acquisition, sale, lease, license, or other disposition of the Company or any technology or any material part of the assets of the Company; (ii) offer to sell or transfer any of the capital stock of the Company or to sell, lease, license, or otherwise dispose of the Company or any material part of the technology or assets of the Company to any person or entity other than Investor or the other Investors; or (iii) disclose financial or other information relating to the Company other than in the ordinary course of its business to any person or entity other than Investor, the other Investors, or their agents and representatives. The Company acknowledges and agrees that the legal remedies available to Investor in the event the Company violates any of the foregoing covenants would be inadequate and that Investor shall be entitled to obtain specific performance, injunctive relief, and other equitable remedies in the event of any such violation.

**Confidentiality:** The Company recognizes that this Term Sheet is confidential and that disclosure of the provisions contained herein could cause irreparable harm to Investor and the other Investors. Accordingly, the Company, and each of the Company's agents, officers, and directors acknowledge and agree that the terms, conditions, and contents of this letter will be kept confidential and will not be published or disclosed except in the following circumstances: (i) disclosure may be made to the Company's directors, officers, employees, or representatives who need to know such information for the purpose of evaluating this proposed investment (it being understood that such persons shall be informed by the Company of the confidential nature of such information and shall be required to treat such information confidentially); or (ii) disclosure may be made with the prior written consent of all Investors.

Investor recognizes that the due-diligence materials provided by the Company to Investor are confidential and that disclosure of these terms could cause irreparable harm to the Company. Accordingly, Investor and its agents, officers, and directors acknowledge and agree that the terms, conditions, and contents of this letter will be kept confidential and will not be published or disclosed except in the following circumstances: (i) disclosure may be made to the other Investors and their directors, officers, employees, or representatives who need to know such information for the purpose of evaluating this proposed investment (it being understood that such persons shall be informed of the confidential nature of such information and shall be required to treat such information confidentially); or (ii) disclosure may be made with the prior written consent of the Company.

**Expiration:** This offer expires in its entirety unless signed and accepted by 5:00 PM [State or Time Zone] time, \_\_\_\_\_, 200\_\_\_\_.

**In Witness Whereof**, the parties have executed this Term Sheet as of the date set forth below:

Agreed And Accepted:

[COMPANY NAME]

[INVESTOR]

By: \_\_\_\_\_

By: \_\_\_\_\_

Name: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

Title: \_\_\_\_\_

Date: \_\_\_\_\_, 200\_\_\_\_

Date: \_\_\_\_\_, 200\_\_\_\_

## [EXHIBIT A]

### [BRIDGE NOTES]

[Investor A]     \$ \_\_\_\_\_

[Investor B]     \$ \_\_\_\_\_

[Investor C]     \$ \_\_\_\_\_

[Investor D]     \$ \_\_\_\_\_

## EXHIBIT [B]

### POST-CLOSING CAPITALIZATION

	AMOUNT OF INVESTMENT	COMMON STOCK EQUIVALENTS	FULLY-DILUTED PERCENTAGE OWNERSHIP
<b>Common Stock</b>			
Founders			
Employee Option Pool*			
<b>Total Common Stock</b>			
<b>Series A Preferred</b>			
Investor			
Other Investors			
[Bridge Note Holders]			
<b>**Total Series A Preferred</b>			
<b>Totals</b>			<b>100.00%</b>

\* Available for issuance.

\*\* Assumes full [\$\_\_\_\_\_] million investment [including conversion of outstanding Bridge Notes].

## APPENDIX 12

### EXPLANATORY TERM SHEET (SAMPLE 2)

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This term sheet summarizes the principal terms with respect to a potential private placement of equity securities of \_\_\_\_\_ (the "Company") by a group of investors led by \_\_\_\_\_. This term sheet is intended solely as a basis for further discussion and is not intended to be and does not constitute a legally binding obligation.

#### PROPOSED TERMS FOR PREFERRED STOCK FINANCING OF (THE "COMPANY")

<b>Amount:</b>	\$_____ at [First] Closing; \$_____ at Second Closing prior to _____, 200__]	
<b>Type of Security:</b>	Series _____ Preferred Stock ("Preferred")	
<b>Price per Share:</b>	\$_____ ("Original Purchase Price")	
<b>Investors:</b>	_____ (collectively, the "Investors")	
<b>First Closing:</b>	[First] Closing on or around _____, 200__	
<b>Capitalization:</b>	<u>Outstanding</u>	<u>Pro Forma</u>
Common Stock		
Preferred Stock		
Options		
Reserved		
Outstanding and unexercised		
Available for grant		
Warrants		
Convertible notes/other securities		

**Comment:** Dividends typically range from 7% to 10% of the Original Purchase Price. Most dividends are noncumulative.

**Comment:** This is a simple participating preferred, which means that the funds remaining after payment of the Preferred's Original Purchase Price will be shared equally by the Common and Preferred shareholders. As drafted, this provision is very favorable to investors because there is no cap on the amount they are to receive.

## RIGHTS, PREFERENCES, PRIVILEGES, AND RESTRICTIONS OF PREFERRED

**Dividends:** Holders of Preferred shall be entitled to receive, prior to any payment of dividends to holders of the Common Stock of the Company (the "Common Stock"), annual dividends payable in the amount of \$\_\_\_\_\_ per share when and if declared by the Board of Directors. *[or, which shall cumulate from year to year annually on the anniversary date of the closing whether or not declared by the Board.]*

**Liquidation Preference:** In the event of any liquidation or winding up of the Company, the holders of the Preferred will be entitled to receive in preference to the holders of Common Stock an amount ("Liquidation Amount") equal to the Original Purchase Price *[or: plus all cumulated dividends]*. After payment of the Original Purchase Price *[or: plus all cumulated dividends]* to the holders of the Preferred, the remaining assets shall be distributed ratably to the holders of Common and Preferred on a common equivalent basis *[ratably to the holders of Common Stock] [or] [ratably to the holders of Common and Preferred on a common equivalent basis until the holders of Preferred have received a total return in the liquidation of three times the Original Purchase Price after which any remaining amounts will be distributed ratably to the holders of Common]*. A merger, acquisition, or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation.

### Conversion

► **Optional:** The holders of the Preferred will have the right to convert their Preferred at their option, at any time, into shares of Common Stock. The total number of shares of Common Stock into which the Preferred may be converted initially will be determined by dividing the Original Purchase Price by the Conversion Price. The initial Conversion Price will be the Original Purchase Price. The Conversion Price will be subject to adjustment as provided in paragraph (iv) below.

**Comment:** The purpose of forcing conversion is to clean up and simplify the Company's capitalization structure at the IPO. Company will want as much flexibility to force conversion (which generally means a 50% threshold), particularly if trying to do IPO in volatile markets when market conditions may cause the offering price to fall below the per-share price that will force conversion. May need to address majority threshold if representing investor that does not own a majority of the preferred. Alternatives include a supermajority threshold or a series vote.

**Comment:** Broad-based weighted average as shown is most typical and favorable to the Company. An alternative is a narrow-based weighted average formula which looks only at the outstanding stock (as opposed to all stock on a fully-diluted basis). Other, more rare, alternatives include a "ratchet" provision which is quite onerous from the Company's perspective as it provides that, upon a down round, the Conversion Price of the Preferred is adjusted downward to the issuance price of the dilutive financing. Another provision, the so-called "pay-to-play" provision, is burdensome to the investors because it requires that investors must participate in dilutive rounds to retain antidilution protection for their shares.

► **Automatic Conversion:** All of the Preferred will be automatically converted into Common Stock, at the then-applicable Conversion Price, in the event that (x) holders of a majority of the Preferred consent to the conversion to Common Stock or (y) upon the closing of an underwritten public offering of shares of the Common Stock of the Company at a public offering price per share (prior to underwriting commissions and expenses) of not less than [2 to 5] times the Original Purchase Price in an offering of not less than \$20,000,000 (the "IPO").

**Antidilution Protection:** The Conversion Price of the Preferred will be subject to adjustment to prevent dilution in the event that the Company issues additional equity securities at a purchase price less than the applicable Conversion Price. [Ratchet alternative: The Conversion Price of the Series \_\_\_\_\_ Preferred will be subject to a "full ratchet" adjustment to reduce dilution in the event that the Company issues shares at less than the Conversion Price. The then-effective Conversion Price shall be reduced to the price paid for such newly issued shares.] The Conversion Price of the Preferred will be subject to adjustment on a broad-based weighted average basis. The Conversion Price shall not be adjusted because of (a) conversion of the Preferred, (b) securities issued to a commercial lender or lessor which is approved by the [entire] board, (c) the sale or grant of options to employees, directors, or consultants to purchase up to \_\_\_\_\_ shares of common stock [or the sale or grant of options to purchase shares approved [unanimously] by the Board of Directors], (d) issuances in acquisitions of another company or assets unanimously approved by the Board, and [(e) any other issuance that is approved by the [entire] Board.] The Conversion Price will also be subject to proportional adjustment for stock splits, stock dividends, recapitalizations, and the like.



### **Voting Rights:**

Other than Directors. The holders of a share of Preferred will have a right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of Preferred.

Directors. The size of the board shall be set at \_\_\_\_\_. The holders of Preferred shall be entitled to elect \_\_\_\_\_ directors. The holders of Common shall be entitled to elect \_\_\_\_\_ directors. The remaining directors shall be elected by the Preferred and Common voting together.

**Comment:** The Company will typically resist a redemption feature on the theory that the expected liquidity will be achieved when the Company goes public or is acquired. The investors may insist on the redemption feature to force the Company to cash them out at some point if the other liquidity options (an IPO or acquisition) have not occurred.

**Comment:** Need to consider threshold vote required: The Company will generally favor a simple majority threshold; however, if we represent the investors and the investors do not hold a majority of the outstanding preferred stock, may need consider a supermajority threshold or a series vote.

**[Redemption at Option of Investor:** At election of the holders of at least 50% of the Preferred, the Company shall redeem [1/3 of the Preferred on the fifth anniversary of the Closing, 1/3 on the sixth anniversary of the Closing and 1/3 on the seventh anniversary of the Closing], each at a redemption price equal to the Original Purchase Price [plus a rate of return equal to 10% per year on the Original Purchase Price [or: plus all cumulated dividends]] minus the amount of any dividends previously paid to holders of Preferred.]

**Protective Provisions:** Consent of the holders of a [majority] of the outstanding Preferred Stock shall be required for: (i) any amendment or change of the rights, preferences, privileges, or powers of, or the restrictions provided for the benefit of, the Preferred; (ii) increases or decreases the authorized number of shares of Common or Preferred Stock; (iii) any action that authorizes, creates, or issues shares of any class of stock having preferences superior to or on parity with the Preferred; (iv) any action that reclassifies any outstanding shares into shares having preferences or priority as to dividends or assets senior to or on parity with the preference of the Preferred; (v) any amendment of the Company's Articles of Incorporation or Bylaws that adversely affects the rights of the Preferred; (vi) any merger or consolidation of the Company with one or more other corporations in which the shareholders of the Company immediately after such merger or consolidation hold stock representing less than a majority of the voting power of the outstanding stock of the surviving corporation; (vii) the sale of all or substantially all the Company's assets; (viii) the liquidation or dissolution of the Company; (ix) the declaration or payment of a dividend on the Common Stock (other than a dividend payable solely in shares of Common Stock);

*[(x) the license by the Company of any of its technology of such a manner as to have the same economic effect as a sale or disposition of all or substantially all of the assets of the Company;] (xi) the repurchase by the Company of any shares of its capital stock, except redemption or repurchase of shares of common stock from employees or consultants upon termination of their employment or service pursuant to agreements providing for such repurchase; or (xii) changes the authorized size of the Company's Board [unless required during a future financing].*

## **RIGHTS AGREEMENT**

### ***Registration Rights:***

***Comment:*** Generally, holders of 30% to 50% must demand registration.

**Demand Rights:** If, at any time that is six months after the Company's initial public offering *[or: If, at any time on or after two years from the Closing Date]*, holders of at least [40%] of the Preferred (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred) request that the Company file a registration statement for all or any portion of the Common Stock issued or issuable upon conversion of the Preferred, having an aggregate offering price to the public of not less than [\$5,000,000], the Company will use its best efforts to cause such shares to be registered, provided, however, that (a) the Company shall not be obligated to effect any such registration within 90 days prior to the filing of, and [90 to 180] days following the effective date of, a registration statement pertaining to an underwritten public offering of the Company's securities, (b) such registration obligation shall be deferred not more than six months from the date of receipt of request from the initiating holders if the Company furnishes the initiating holders with a certificate of the Chairman of the Board stating that in the good-faith judgment of the Board, it would be seriously detrimental to the Company and its shareholders for such registration statement to be effected at such time, provided that the right to delay a request may be exercised by the Company not more than once in any 12-month period, and (c) the Company shall not be obligated to effect more than [two] such demand registrations. Any such registration shall be firmly underwritten by an underwriter of nationally recognized standing.

**Comment:** Registrations on Form S-3 not possible until one year after IPO; shorter form, much less expensive. Typically, offering must be between \$1 million and \$5 million.

**Comment:** Limit underwriter “cutback” after IPO; typically 20-30%.

**Comment:** Founders may be given limited or subordinate rights. Important to define Founders who will have this right and who will be subject to Right of First Refusal and Co-Sale Agreement (see below).

**Comment:** Underwriter “lock-up” provisions are typically 180 days for IPOs. Some investors want no more than 90 days agreed to in advance to preserve ability to negotiate a shorter lockup period with underwriters. This may, however, create a burden later in getting numerous investors to agree to extend the period at the time of the IPO.

**Comment:** Condition “lockup” on agreement of officers, directors and holders of 1% or more of the Company’s securities being subject to same restrictions.

**Registrations on Form S-3:** Holders of at least 20% or more of the Preferred (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred) with proceeds of at least [\$5,000,000] will have the right to require the Company to file one registration statement annually on Form S-3 with respect to Common Stock issued upon conversion of the Preferred.

**Piggyback Registration:** The Investor [and \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_ (collectively, the “Founders”)] will be entitled to “piggyback” registration rights with respect to offerings registered by the Company, subject to the right of the Company and its underwriters, in view of market conditions, to reduce (but to no less than 30% of any offering after the IPO) the number of shares of the Investor [and Founders] proposed to be registered. [All shares proposed to be registered by the Founders shall be cut back prior to any reduction of the number of shares proposed to be registered by the Investor.]

**Registration Expenses:** The registration expenses (exclusive of underwriting discounts and commissions) of all demand registrations, Form S-3 registrations, and piggyback registrations will be borne by the Company.

**Transfer of Registration Rights:** The registration rights may be transferred to a transferee (other than a competitor of the Company) who acquires at least 10% of the Investor’s shares. Transfer of registration rights to a partner, affiliate, or related entity of the Investor will be without restrictions as to minimum shareholdings.

**Other Registration Provisions:** Other provisions will be contained in the Rights Agreement with respect to registration rights, including cross indemnification, the agreement by Investors if requested by the underwriter in a public offering not to sell any Common Stock that they hold for a period of 180 days following the effective date of the registration statement for the IPO or 90 days following a subsequently public offering (subject to all directors, officers, and holders of 1% or more of the Company’s securities entering into similar agreements), the period of time in which the registration statement will be kept effective, underwriting arrangements, and the like.

**Comment:** *If we represent the Company, we will want to be able to grant rights pari passu with the registration rights contained in the Rights Agreement. Investors should agree to this if the new rights holders are cut-back prior to any investor being cut-back.*

**Comment:** *Depending on composition of investors, may want a threshold other than a simple majority. Company will probably prefer a simple majority threshold.*

**Comment:** *The Company will want simpler termination language, such as, "upon any three-month period when the Investors can sell all of their shares pursuant to Rule 144."*

**Comment:** *Information rights and inspection rights should have the same percent threshold. Will want threshold high enough so that each small investor does not have these rights, but each primary investor does have these rights.*

**Comment:** *Sometimes information rights and inspection rights will terminate if an investor begins converting some of its preferred stock.*

**Granting of Subsequent Registration Rights:** The Company shall not grant registration rights to any third party that are superior to [or pari passu with] the registration rights set forth in the Rights Agreement without the prior written consent of holders of a [majority] of the Preferred.

**Termination of Registration Rights:** The registration obligations of the Company shall terminate five years after the initial public offering. In addition, the registration rights will terminate if (i) the Company has completed its IPO, (ii) an Investor (together with its affiliates, partners, and former partners) hold less than [1%] of the Company's outstanding Common Stock (treating all shares of convertible preferred stock on an as-converted basis) and (iii) all such stock held by an Investor (and its affiliates, partners, and former partners) may be sold under Rule 144 during any ninety (90)-day period.

### **Information Rights:**

So long as an Investor holds not less than [5% to 15%] of the total Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred), the Company will deliver to the Investor audited annual and unaudited quarterly financial statements. So long as the Investor holds not less than \_\_\_\_\_% of the total Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred), the Company will timely furnish the Investor with budgets and monthly financial statements. These obligations of the Company will terminate upon a public offering of Common Stock [or at such time as an Investor has converted more than [50%] of its Preferred into Common Stock].

### ***Inspection Rights:***

The Company shall permit an Investor that holds not less than \_\_\_\_% of the total Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred) to visit and inspect the properties of the Company, including its corporate and financial records, and to discuss its business and finances with officers of the Company during normal business hours following reasonable notice.

### ***Right of First Refusal:***

***Comment:*** Important to define the investors who will have this right (generally the same as the ones who have information and observation rights) and which issuances of equity securities will not trigger this right.

***Comment:*** Sometimes investors will want right to subscribe for more than their pro-rata portion, including, in some rare cases, all of a future financing.

In the event the Company offers equity securities (other than (i) options reserved at the Closing under the Company's option plans, (ii) upon conversion of outstanding Preferred, (iii) upon exercise of outstanding options or warrants, (iv) in connection with an acquisition or a public offering that is approved by the [entire] board[, including the \_\_\_\_\_ director], or (v) in connection with an equipment lease or commercial lending arrangement that has been approved by the [entire] board[, including the \_\_\_\_\_ director], each Investor who holds not less than \_\_\_\_% of the total Preferred issued in the financing (or Common Stock issued upon conversion of Preferred or any combination of such Preferred and Common Stock) shall have a right of first refusal to purchase such portion of those equity securities as to maintain its pro-rata ownership interest in the Company. This right shall terminate upon the closing of an IPO or an acquisition of the Company [or at such time as an Investor has converted more than [50%] of its Preferred into Common Stock].

### ***Miscellaneous Provision: Amendment/Waiver of Rights Agreement***

***Comment:*** Depending on composition of the investors, may want to adjust threshold, though Company will prefer a majority threshold.

No right may be waived and the Rights Agreement may not be amended without the approval of the Company and the holders of a [majority] of the Preferred.

*Comment: The percent of stock that Founders may transfer free of any restrictions ranges from 1% to 10%; generally, 5% is standard.*

*Comment: The release of Founder's shares from Company right of repurchase is highly negotiated at the time of first venture financing. Generally, the Founder will be given some credit for work done prior to financing so not all Founder's shares will be subject to right of repurchase. The Founder's remaining shares will be released from the repurchase option either monthly thereafter (which is typical) or some portion one year after the financing and then monthly thereafter.*

## RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT

**Right of First Refusal:** Except for gifts to a spouse or children, or transfers to the estate of a deceased shareholder, or transfers of up to [1% to 10%] of all of the Founder's stock (including all preferred and common stock), a Founder may not transfer any shares of the Company's capital stock now owned or hereafter acquired without first offering it to the Company and then to the Investors. [If an Investor does not exercise its pro-rata right, other Investors that exercise their right may purchase the non-participating Investor's portion.]

**Put Right:** In the event a Founder transfers his shares in violation of this Right of First Refusal and Co-Sale Agreement, the Investors shall have the right to put a pro-rata portion of their shares to such Founder.

## FOUNDER STOCK-RESTRICTION AGREEMENT

Each Founder will execute a stock-restriction agreement with the Company pursuant to which the Company will have a repurchase option to buy back at cost a portion of the shares of stock held by such person in the event that such shareholder's employment with the Company is terminated, prior to the expiration of \_\_\_\_ months from the date of the Preferred Stock Purchase Agreement (the "Measuring Date"). A portion of the shares will be released from the repurchase option based upon continued employment by the Company as follows: [\_\_\_\_\_% will be released from the repurchase option as of the date of the Preferred Stock Purchase Agreement; an additional \_\_\_\_% will be released from the repurchase option on the first anniversary of the Measuring Date, and an additional \_\_\_\_% will be released on the completion of each month thereafter.]

*Comment:* You will need to think through the representation and warranties. Generally, Investors want cleaner reps and warranties with fewer qualifiers (knowledge and materiality), while the Company will want fewer reps and warranties and more qualifiers.

*Comment:* Key-man insurance is good source of funds for redemption in early-stage company, if investors have requested the right of redemption.

*Comment:* Investor's counsel usually capped between \$10,000 and \$30,000.

## OTHER AGREEMENTS AND CONDITIONS

**The Preferred Stock Purchase Agreement:** The purchases of the Preferred will be made pursuant to a Preferred Stock Purchase Agreement reasonably acceptable to the Company and the Investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein and appropriate conditions to closing which will include, among other things, qualification of the shares under applicable Blue Sky laws, the filing of Amended and Restated Articles of Incorporation, and receipt of an opinion of counsel. The Preferred Stock Purchase Agreement shall provide that it may only be amended and any waivers thereunder shall only be made with the approval of the holders of a majority of the Preferred.

**Proprietary Information and Inventions Agreement:** Each officer and employee of the Company will enter into a proprietary information and inventions agreement with the Company.

**Key Man Insurance:** [\$1,000,000] policy on the lives of each of the Founders, with the Company as beneficiary [but with proceeds to be applied to redemption of Preferred Stock at the election of holders of the majority of Preferred.]

**Finders:** The Company and the Investors shall each indemnify the other for any broker's or finder's fees for which either is responsible.

**Expenses:** The Company and the Investors will each bear their own legal and other expenses with respect to the transaction (except that, assuming a successful completion of the transaction, the Company will pay reasonable legal fees and expenses incurred by counsel to the Investors, up to \$\_\_\_\_\_).

**Comment:** If representing the Company, try to delete bracketed language re [in their sole discretion].

**The Closing:** The Closing of the purchase of the Preferred will be conditioned upon the following:

- ▶ Completion of due diligence to the satisfaction of the Investors [in their sole discretion];
- ▶ Compliance by the Company with applicable securities laws;
- ▶ Opinion of counsel to the Company rendered to the Investors in form and substance satisfactory to the Investors and their counsel;
- ▶ [Other material conditions];
- ▶ Such other conditions as are customary for transactions of this type.

## CORPORATE INVESTORS

**Comment:** Should receive careful consideration when a corporate investor is investing.

**Confidentiality [and Standstill]:** Each corporate investor will enter into a confidentiality agreement covering standard information disclosed by the Company [and a standstill agreement for a period of five years] [and will enter into a voting agreement agreeing to vote all shares [in the event of a merger or acquisition of the Company or a sale of all assets] in the same manner as the majority of all other shareholders]. Further, to avoid conflicts of interest, any director [or observer] affiliated with such investor may be excluded from any portion of any Board meeting when the majority of the other Board members deems it to be appropriate to protect the interests of the other stockholders.



## OTHER MATTERS

In consideration of the Investors' commitment of substantial resources to perform and complete a due-diligence review of the Company, the Company agrees that during the period between the acceptance of this Term Sheet and \_\_\_\_\_, 200\_\_\_\_, the Company shall not enter into or continue discussions with any third party, either agent or principal, concerning a possible investment, public offering, merger, acquisition, or other business arrangement. If for any reason the Investors decide not to proceed with this investment, they will provide immediate written or verbal notice to management of the Company, and all terms, including the "exclusivity" outlined above, will terminate upon such notice.

This offer will expire if not accepted by \_\_\_\_\_.

Agreed and Accepted

\_\_\_\_\_  
[Company]

\_\_\_\_\_  
[Investors]

Date: \_\_\_\_\_

Date: \_\_\_\_\_

Counsel for the Company is:

Counsel for the Investors is:

## APPENDIX 13

### ANGELS ANONYMOUS<sup>1</sup> PUBLIC SURVEY

**Note:** A better understanding of public perception and opinion can help in the growth and sustainability of your angel group. Numerous perspectives would be most valuable and may be better distributed in separate surveys to those selected groups. As such, the survey below contains sections directed at different audiences, which you may wish to separate into different market-specific surveys. Obviously, you will want to add questions unique to your group or community. Remember to keep the survey simple and easy to respond (minimal time). Many organizations use on-line surveys, which can make response quite efficient and may even have features for automatic data compilation. Let your audience know that individual results will be kept confidential and only compiled results will be shared publicly.

Scoring: 1= Unsatisfactory    2= Weak    3= Satisfactory    4= Good    5= Excellent    NI=No Information

GENERAL AUDIENCE AND/OR MEMBERSHIP	SCORE
<b>1. How did you first hear of Angels Anonymous?</b> (check all that apply) <input type="checkbox"/> Friend/personal acquaintance <input type="checkbox"/> News media <input type="checkbox"/> Professional acquaintance <input type="checkbox"/> Investment event <input type="checkbox"/> AA Web site <input type="checkbox"/> VC or investment banker <input type="checkbox"/> Company applied to AA <input type="checkbox"/> Company received AA investment <input type="checkbox"/> Other: _____	
<b>2. What has your impression been of AA in:</b> a. Membership criteria and standards? b. Membership experience and expertise? c. Attention to membership needs? d. Ability to gain information about AA? e. In comparison, overall, to other angel groups?	1   2   3   4   5   NI 1   2   3   4   5   NI 1   2   3   4   5   NI 1   2   3   4   5   NI 1   2   3   4   5   NI
<b>3. In what industry(s) do you believe AA members invest?</b> (check all that apply) <input type="checkbox"/> Health care <input type="checkbox"/> Telecommunications <input type="checkbox"/> Media <input type="checkbox"/> Manufacturing <input type="checkbox"/> Environment <input type="checkbox"/> Biotechnology <input type="checkbox"/> Business/Financial <input type="checkbox"/> Energy <input type="checkbox"/> E-Commerce <input type="checkbox"/> Industrial <input type="checkbox"/> Software <input type="checkbox"/> Consumer products <input type="checkbox"/> Agriculture <input type="checkbox"/> Semiconductors <input type="checkbox"/> Other: _____	

<sup>1</sup> "Angels Anonymous" is a fictitious angel group and is merely a name used for example purposes.

GENERAL AUDIENCE AND/OR MEMBERSHIP (continued)	SCORE					
4. What is your impression of AA's investment criteria?	1	2	3	4	5	NI
5. What is your impression of AA's investment rate? (i.e., number of deals done)	1	2	3	4	5	NI
6. How would you compare AA to other angel groups?	1	2	3	4	5	NI
7. How would you compare AA to venture capital funds?	1	2	3	4	5	NI
<b>8. Considering angel organizations in general, rank the following statements with regard to your understanding of group function or role in funding companies: (Rank with 1 highest)</b>  _____ Primary funding source for entrepreneurs _____ Primary funding source for small companies with modest revenue potential (less than \$20 million) _____ Companies in which angel groups invest in nearly always need venture capital or some further institutional investment _____ Companies in which angel groups invest in nearly always get venture capital or some further institutional investment _____ Angel groups are competitive to venture capitalists _____ Angel groups are essentially the same as venture capitalists						
<b>APPLYING COMPANIES</b>						
<b>1. How did you find out about AA?</b> (check all that apply) <input type="checkbox"/> Friend/personal acquaintance <input type="checkbox"/> News media <input type="checkbox"/> Professional acquaintance <input type="checkbox"/> Investment event <input type="checkbox"/> AA Web site <input type="checkbox"/> VC or Investment banker <input type="checkbox"/> Company which applied to AA or received AA investment <input type="checkbox"/> Other: _____						
2. Did you find the information-submission requirements understandable?	1	2	3	4	5	NI
3. Did you understand the screening and selection criteria?	1	2	3	4	5	NI
4. Did you understand the screening and selection process?	1	2	3	4	5	NI
<b>5. Were you chosen for presentation?</b> <input type="checkbox"/> Yes <input type="checkbox"/> No						

APPLYING COMPANIES (continued)	SCORE					
6. If you were chosen for presentation, how valuable was the presentation coaching?	1	2	3	4	5	NI
7. Whether or not you were chosen for presentation, did you find the feedback provided valuable and substantive?	1	2	3	4	5	NI
8. Did you understand the reasons you were, or were not, chosen to present? <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Somewhat						
9. Was your interaction with AA constructive for your company?	1	2	3	4	5	NI
10. If you were selected as a presenter, did you receive any funding from an AA member? <input type="checkbox"/> Yes <input type="checkbox"/> No						
11. If you were selected as a presenter, did you receive any funding from any other investors? <input type="checkbox"/> Yes <input type="checkbox"/> No						
12. Please indicate the stage of your company at this time: (check one that applies) <input type="checkbox"/> Start-Up: idea stage, no product or sales <input type="checkbox"/> Seed: initial development, but no products sold <input type="checkbox"/> Early: most product development done and initial sales begun <input type="checkbox"/> Developmental: product development mature and focused on selling						
13. As a source of funding, how would you compare AA to:						
a. Other angel organizations	1	2	3	4	5	NI
b. Venture capitalists	1	2	3	4	5	NI
c. Traditional banks	1	2	3	4	5	NI
14. Would you recommend AA to other entrepreneurs? <input type="checkbox"/> Yes <input type="checkbox"/> No						

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E W I N G M A R I O N  
KAUFFMAN FOUNDATION

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