

ABRAMS FENSTERMAN

Abrams, Fensterman, Fensterman, Eisman, Greenberg, Formato & Einiger, LLP

Attorneys at Law
www.abramslaw.com

630 Third Avenue - 5th Floor
New York, New York 10017
Phone: 212-279-9200
Fax: 212-279-0600

1111 Marcus Avenue - Suite 107
Lake Success, New York 11042
Phone: 516-328-2300
Fax: 516-328-6638
FAX NOT FOR LEGAL SERVICE

500 Linden Oaks - Suite 130
Rochester, New York 14625
Phone: 585-218-9999
Fax: 585-218-0562

FINANCING ALTERNATIVES FOR TECHNOLOGY COMPANIES

By Neil M. Kaufman, Esq.

Obtaining financing is a challenge that almost all high-growth companies will face at some point. The senior executives of these companies who have not had experience in the financing process generally have the same questions:

- How will I get the money I need to grow my business?
- Where should I look for needed financing?
- What types of financing are available for my company?
- What is the process that I will need to go through?

The answers to these questions are simple, especially with the benefit of qualified professional advisors. In this article, we will provide basic answers to these questions that will provide a foundation of information needed to proceed with obtaining financing. We have also included a more detailed outline of financing methods and their processes, which is attached as Appendix A, for those readers who wish to have more detail. For any further questions, please do not hesitate to contact us directly.

Financing Options

The available financing options vary depending on your goals, preferences, industry and other factors. We will focus primarily on equity financing, since bank debt is often unavailable to early stage and technology companies. The basic methods of financing that

should be considered include personal sources, friends and family, angel investors, venture capital, private placements, and initial public offerings. Obviously, not all of these alternatives are available to everyone, and their availability will depend in part upon what stage the company is in and the state of the market at the time. Some of these options are often overlooked, and many people used to want to skip right to an initial public offering. A few years ago, an IPO was possible very early in the life of a company, but today start-up companies have a long way to go before being ready for an IPO.

Basic Considerations

No matter which financing option you wish to pursue, and no matter what the state of the market is, there are some basic considerations that will always apply:

1. First and foremost, you must have a clear and concise business plan with an attention-grabbing executive summary at the beginning. The first paragraph of the executive summary must explain powerfully your business, the market you are going to exploit and why you will be successful at exploiting that market. If you are not able to succinctly describe to a potential investor how and why you will succeed, your financing efforts will quickly stall.

2. The introduction to the financing source is critical in most cases. Potential investors receive many business plans every day. The business plans that arrive without an introduction are often simply discarded. If you know somebody (i.e, an accountant, lawyer, or business contact) who can introduce you to the potential financing source and can vouch for you, your company and your company's potential, it is far more likely that your business plan will be well received and you will be able to set up a face-to-face meeting to discuss your plans.

3. Organization is also a very important element in almost all financings. Any corporate clean-up that is needed should be done prior to any serious discussions with a potential

financing source or any due diligence that they might do. All due diligence requests from potential investors should be responded to quickly and in an organized fashion. A good way to impair your chances to get funding is to provide a potential funding source with requested information in a haphazard and disorganized way.

Process

The process that you will need to go through to accomplish a financing will vary based on the type of financing. Basically, however, most financings will follow a similar pattern: introduction to a financing source, due diligence and negotiation of terms (in either order, and often simultaneously), drafting of documentation, and finally execution of documentation and funding.

Sources

1. *Personal Sources*

The most basic and often quickest way to raise money, and the one that is least affected by a down market, is from personal sources. Bank accounts, credit cards and home equity lines of credit are all quick and easy ways to obtain necessary capital for a business. Raising money in this fashion avoids bringing outside ownership into the company. Of course, you risk financial ruin and can incur high credit card interest rates in the process. You also may not be able to raise enough money to fund your business plan in this fashion. If you truly believe in your business and you are a start-up, however, this will most likely be your first source of funding. Future financing sources will look to see how much you have invested in the business, because if you have not been willing to invest in your own business, then why should they?

2. *Friends and Family*

A second way that has the potential to be a relatively quick and easy way to raise capital is through friends and family. Because the financing source is known to you, and presumably is comfortable with your skills and abilities, this method of financing can be a relatively easy transaction in which you likely will be able to get more favorable terms (of course, all of this depends upon who your friends and family are). You can structure this as a simple debt transaction through the use of a basic promissory note, a simple equity transaction through the use of a business plan with a term sheet and risk factors (if all of your investors are accredited or sophisticated), or it can be as complicated as a full-blown private placement (which is described below). The downside to this type of transaction, of course, is the potential personal and emotional consequences of having business dealings with your friends and family. Further, since friends and family may be unsophisticated, time may be wasted and you may not be able to raise all of the money that you need in this fashion.

3. *Angel Investors*

Another source of funding is angel investors. These are wealthy and generally experienced business people, doctor/dentist networks or groups of accredited investors. In many cases an angel investor will have knowledge of the business that you are in, and can provide you with business advice and contacts in the field. This can be a great asset, but can also be a problem if the investor is insistent on providing unwanted business advice. A funding from an angel can take many forms, from simple to complex. Traditionally, the terms are not as onerous as a venture capitalist (described below) would request, and the documentation can be simpler. However, this has been changing as angel investing has become more common and sophisticated.

4. *Venture Capital*

Another type of private funding can be obtained through a venture capitalist. This type of financing will generally contain among the most onerous terms of any type of financing, especially in recent times as many struggling venture capital funds have sought to almost guarantee huge returns to make up for their “dot com” losses. A venture capital firm will take substantial equity and board representation and you may even lose control of the company in certain circumstances, particularly if your projected results are not achieved. The transaction costs are usually fairly high and the process can be lengthy. If you are looking to raise a large amount of money privately, however, this can be a good way to go. Also, you can expect to get business advice from a venture capital firm, which, as described above, can be both good and bad. In the case of a venture capital firm, however, you will be far less likely to be able to disregard such advice. Venture capitalists also can provide access to their network of contacts (including underwriters), and even send you customers and suppliers. This can often be a huge benefit to an early stage company. A good venture capitalist can be a tremendous help to growing a company.

5. *Traditional Private Placement*

Another type of funding is a traditional private placement. This can be accomplished through a placement agent (typically a broker-dealer) or the company can sell to investors directly. If selling through a placement agent, the offering will usually be targeted to either retail or institutional investors. The private placement can be done on a “mini-max,” “best efforts,” or “all or none” basis. Typically a private placement memorandum will be used, although a business plan with a term sheet and risk factors can suffice in certain cases, particularly if the offering is being made to institutional investors. Institutional private

placements then tend to take on many similarities to venture capital transactions. A placement agent private placement has the potential to raise large amounts of money and can get an underwriter interested in doing an initial public offering at some point in the future. The downside to this type of funding is that it can be a lengthy, expensive and cumbersome process, and you may end up raising little or no money despite incurring a large amount of expenses.

6. *Initial Public Offering*

The final type of funding is the one that the general public is most familiar with: the initial public offering. An initial public offering can be done with an underwriter or without, although doing one without an underwriter is very difficult, especially in today's market. An IPO has many benefits. It allows you to raise large amounts of money and can create a high profile for your company. It also provides liquidity in your stock which then allows stock to be used for future acquisitions and attracting and incentivizing employees. There are downsides as well. Of all of the type of financings discussed, this can be by far the lengthiest and most expensive, even if it is never closed. There will be extensive disclosure requirements. There usually will be no liquidity for the principals for at least six months. An IPO is always subject to the vagaries of the public markets, and the market for your stock may not be the same when you start as when you wish to close, thus leaving you with a lot of expenses and little or no money to pay them.

7. *Public Shell*

With the recent bear market for IPOs, many companies have sought to "go public" through the "back door," by merging with an existing public company that has little or no other business, thus taking over the "public shell." While this is not a financing transaction, if the public shell has cash, by merging into it and taking control, management of the company

seeking financing effectively has raised capital and become a public company. This type of transaction historically was frowned upon, but has gained increased acceptance in recent years as an alternative to an IPO.

While the above-described financing methods are not exhaustive of the various ways to raise capital, they are the most common methods that most companies will encounter. Many companies utilize most or all of the aforementioned types of financing at some point during their existence. For more detail regarding the various methods of financing and the process related to each, and for some pros/cons and practical tips related to the financing process, see the attached Appendix A.

APPENDIX A
FINANCING ALTERNATIVES
FOR TECHNOLOGY COMPANIES

FINANCING SOURCES:

- I. **Personal sources:** Bank accounts, credit cards, home equity lines of credit

<u>Pros</u>	<u>Cons</u>
Quick and easy No outsiders	High rates of interest Risk of damage to personal finances May not be able to raise enough money

Process: Go to bank, use credit cards, etc.

2. **Friends and Family:** Friends, family, neighbors, acquaintances

<u>Pros</u>	<u>Cons</u>
Can be quick May get favorable terms (debt or equity) Initially friendly investors	Personal/Emotional Complications Unsophisticated investors may waste time May not be able to raise enough money

Process:

- (a) Negotiate terms and draft appropriate documentation: complexity ranges from simple promissory notes to the same level as a self-offering private placement (described below)
- (b) For an equity transaction, you will generally use a disclosure document and a subscription agreement
- (c) Sometimes you can use a business plan with a term sheet and risk factors for disclosure purposes
- (d) Execution of documentation and funding

3. **Angel Investors:** Wealthy and generally experienced business people, doctors/dentist networks, accredited investor(s)

<u>Pros</u>	<u>Cons</u>
Business advice/contacts from angel Traditionally, terms not as onerous as venture capital terms	Business advice from angel Limited amounts of money in certain cases Hard to find Potentially lengthy process

Process:

- (a) Introduction to angel - need business plan with concise executive summary
- (b) Negotiation of terms
- (c) Angel investor does due diligence
- (d) Drafting of appropriate documentation for the transaction
- (e) Execution of documentation and funding

4. **Venture Capital:** Investors with valuation expertise and funding for high-growth opportunities

<u>Pros</u>	<u>Cons</u>
Can raise large amounts of money Business input from VC's VC contacts for business and with underwriters	Higher minimum amounts for many investors Possible loss of control - VCs take substantial equity and board representation Claw-backs if projected results not achieved Expensive transaction costs Often lengthy process

Process:

- (a) Introduction to venture capital firm is critical- need business plan with concise executive summary; and must impress them with first paragraph.
- (b) Negotiation of terms - watch out for terms that could lead to potential loss of control
- (c) Venture capitalist does its due diligence - be well organized in responding to requests for documentation
- (d) Drafting of appropriate documentation
- (e) Execution of documentation and funding

5. **Private Placement:** Offering to a limited number of investors, usually only accredited investors

<u>Pros</u>	<u>Cons</u>
Can raise large amounts of money Can get underwriter interested	Lengthy and cumbersome process Expensive May not raise any minimum amount

Process for Private Placement using a Placement Agent:

- (a) Introduction to placement agent - need business plan with concise executive summary
- (b) Negotiate and execute engagement letter - offering can be done on a “best efforts”, “mini-max” or “all or none” basis
- (c) Placement agent performs due diligence - very helpful to be well organized; do corporate clean-up quickly and well
- (d) Draft Private Placement Memorandum and Subscription Documents
- (e) Negotiate and execute Placement Agent Agreement and Escrow Agreement
- (f) Placement Agent circulates Private Placement Memorandum
- (g) One or more closings
- (h) Blue Sky

Process for Direct or Self-offering Private Placement:

- (a) No Placement Agent
- (b) Draft Private Placement Memorandum and Subscription Documents
- (c) Circulate Private Placement Memorandum and Subscription Documents
- (d) One or more closings
- (e) Blue Sky

6. **Initial Public Offering:** Offering to the public

<u>Pros</u>	<u>Cons</u>
Can raise large amounts of money High profile Can be “branding event” Liquidity in stock for acquisitions, employee incentivization, principal cash-out	Lengthy process Expensive, even if never closed Extensive disclosure requirements No liquidity for principals for at least 6 months after IPO Subject to vagaries of public markets

<u>Do</u>	<u>Don't</u>
Hire strong CFO Assemble professional team: attorneys, accountants Be informed of other industry deals Clean up corporate books quickly Help accountants stay timely Organize due diligence response (makes good impression)	Try to do everything yourself Rely on small-time or unsophisticated advisors Count on your underwriter to look out for your valuation or offering price Send documents haphazardly to underwriters and their counsel, counting on them to police Ask auditors to do everything Grant preemptive rights

Process for underwritten IPO:

- (a) Introduction to underwriter - need business plan with concise executive summary
- (b) Negotiate and execute letter of intent
- (c) Due diligence - very helpful to be well organized; do corporate clean-up quickly and well
- (d) Draft registration statement - drafting sessions with underwriter and underwriter's counsel
- (e) File Registration Statement with SEC and apply for Nasdaq listing
- (f) 30-day (at least) SEC review
- (g) File one or more amendments to the Registration Statement
- (h) Road Show - no written documents
- (i) Clear Registration Statement with SEC and Nasdaq and go effective
- (j) Underwriting agreement - only signed upon effectiveness - no firm deal until then: underwriter may have pricing leverage since Company has already incurred costs and may need the IPO.
- (k) Negotiate lock-ups with underwriter
- (l) NASD Underwriting Compensation review/regulation
- (m) Blue Sky
- (n) Design option/equity incentive plan - beware of performance-based vesting and escrow shares
- (o) Construct Board of Directors - need 3 independent directors to get listed on Nasdaq (audit and compensation committees)

7. **Merger with Public Shell:** Merge into entity that is already public that has no or little current operations

<u>Pros</u>	<u>Cons</u>
Liquidity in Stock for acquisitions, employee incentivation, principal cash-out Avoid IPO process Access to capital markets	You get restricted stock Need market support Taint

Process:

- (a) Introduction to public shell
- (b) Negotiate and execute letter of intent
- (c) Both sides will perform due diligence
- (d) Draft Agreement and Plan of Merger and any other appropriate documentation
- (e) Closing
- (f) File merger documents with appropriate states