Structuring and Financing Your Medical Device Company

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Table of Contents

STRUCTURING AND FINANCING YOUR MEDICAL DEVICE COMPANY 1

- Initial Corporate Structuring Steps 1
  - Introduction 1
  - Choosing a Vehicle to Carry on Your Business 1
  - Incorporation 1
  - Founders' Shares 2
  - Vesting 3
  - Shareholders' Agreements 3
  - Financing Plan 5
  - Stock Option Plan 7
- Preparing for Financing 8
  - Types of Financing 8
  - Seed Financing Overview 12
  - Preparing the Pitch 13
  - The Essence of the Pitch 13
  - Financing Sources 14
  - Financing Through Business Structure 17
  - Government Assistance 18
- Additional Readings and Resources 19

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Structuring and Financing Your Medical Device Company

This chapter provides a guide to structuring and financing your medical device company. The first part provides guidelines on how to structure your company to ensure that the founders are properly positioned and to maximize your chances of successfully financing your company. The second part provides guidelines on how to successfully finance your company.

Initial Corporate Structuring Steps

Introduction

It is good idea to have a financing plan in place before approaching angels, investment bankers, venture capitalists and underwriters (collectively referred to as "financiers" in this chapter) for financing. Doing the proper planning initially will ensure that your company is properly structured in a way that meets the needs of its founders, the directors, officers, employees and advisors who will be added as the company grows, and the financiers who will be approached for financing.

Choosing a Vehicle to Carry on Your Business

The first consideration in establishing your business is choosing the appropriate legal vehicle. There are three options; a sole proprietorship, a partnership and a corporation. A sole proprietorship is appropriate where a single person will be running the business and the business is fairly simple. A partnership, including a limited partnership, may be appropriate where the venture will be incurring losses in the first few years and investors wish to be able to access those losses directly for tax purposes. A corporation is the vehicle of choice for most medical device ventures because of its limited liability and its simplicity. The ultimate choice will depend on an assessment of advantages and disadvantages and should be made with the assistance of your legal and tax advisors. This chapter assumes that your venture will be carried out through a corporation.

Incorporation

There are a number of choices for jurisdiction of incorporation, and each one has certain advantages and disadvantages. For a B.C.-based company, the two main choices are the *Business Corporations Act* (British Columbia) and the *Canada Business Corporations Act* ("CBCA"). The B.C. statute is the easiest and probably the cheapest. Occasionally, where your company expects to have a large U.S. presence, it may be appropriate to incorporate under a U.S. statute, such as the General Corporation Law of the State of Delaware. Your legal advisor will be able to assist you in choosing which jurisdiction best meets your particular needs.

We recommend that your company start with an authorized share capital of an unlimited number of common shares and 100,000,000 "blank-check" preferred shares. Blank-check preferred shares are a class of preferred shares which let the directors roll out series of preferred shares in the future, each of which series could have different rights and restrictions. This allows the company maximum flexibility to respond to financing opportunities.

In the initial stages, we recommend that most or all of the founders of the company be appointed the initial directors of the company. The build-out of the company's board of directors should not occur until after the company has been structured.

Founders' Shares

In most start-up companies, there are typically two to four initial founders. These individuals also typically form the initial management team. Prior to issuing any other shares, it is essential to have the founders properly positioned in the initial equity of the company. This step has to be done right as it is extremely difficult, if not impossible, to do it later in the life of the company.

Typically, when a new company is formed it has no funds in it unless the founders put some cash into it themselves. While they may put some funding into the company for shares, it is very common that they will purchase a large number of common shares (referred to as "founders' shares") at a very low price (usually no more than a penny per share and often much less) with the low price being recognition of the fact that the founders are spending a considerable portion of their time building the company without being paid for their time.

We typically recommend that founders subscribe for somewhere between 4.0M and 6.0M shares, at nominal consideration ($0.0001 per share). The number will depend upon how many founders there are and how much dilution (see "Financing Plan" on page 5) the founders contemplate.

Many founders make the mistake of allocating all of these shares to the initial founders, without leaving provision to bring in additional management. While stock options can be used to bring in additional management, sometimes this isn't enough. Further, the founders often encounter difficulty getting the new additions to the management team to commit to the same level as the founders when they find out how many shares the founders have. In some situations, it actually becomes a serious problem resulting in resentment being built up in the ranks.

To really attract strong talent to these positions and to motivate them well, some founders' shares should be set aside for the senior positions identified in the company's human resources plan. One method often used is the creation of a trust which holds the shares set aside for future senior officers until those individuals are retained at which point the shares are transferred to them. This is referred to as a "founders' trust". Another method is for one founder to hold the entire block of founders' shares and then transfer them to the new senior officers as they join the company. A third method is to issue a block of founders' shares to a holding company which in turn transfers them to the new senior officers. All of these strategies have tax consequences and your tax advisor should be consulted before implementing any of them.

The founders might also transfer assets to the company in exchange for shares. This could include intellectual property, office furniture, laboratory equipment, computers, hardware, vehicles or any other asset the company might need. These asset transfers may also have tax consequences and tax advisors should be consulted before they are undertaken.

Vesting

The founders may want to consider applying vesting provisions to these founders' shares. By vesting, we mean that the shares are issued up front (the holders will be able to vote them) but that they will be held in escrow by an independent third party escrow agent to be released to the founders over a period of time, typically two to four years. The escrow agreement will provide that if the individual leaves the company prior to a vesting date, the shares that have not then vested will either be returned to the treasury of the company for cancellation, or be transferred at the direction of the Board. The latter allows the board to transfer those shares to a new member of the management team brought in to replace the one leaving.

The reason vesting provisions were created is because of the belief that if one of the founder's leaves, he or she should not be carried for a ride on the backs of the founders who go on to build the company. A second reason is to keep the initial founders participating in the building of the company for a protracted period of time.

Vesting can be simply a time driven formula or it can be attached to milestones in the company. As an example, a vesting schedule might say that the shareholder will receive, out of escrow, 10% of his or her shares upon signing on with the company and 15% each six months thereafter so long as he or she is still working for the company. That way it will take three years for the shares to fully vest.

An example of a milestone driven vesting formula would be something as follows: the shareholder will receive, out of escrow, 25% upon delivery of five sales of the company's product, 25% for the next ten sales, 25% for the next 20 sales and the remaining 25% for the next 30 sales.

While milestone driven vesting schedules seem much more desirable, we typically recommend that time driven formulas be used. Because milestones can be subjective and can result in disputes and hard feelings. By tying it to time, the company can always release an under-performing employee and thus still effectively accomplish the same objectives of the milestone formula.

We recommend that in no case should a new person joining the company vest any shares for at least six months (to ensure that they pass their probationary period).

Shareholders' Agreements

The principal shareholders of the company may consider entering into a shareholders' agreement in certain circumstances. A shareholders' agreement is an agreement among some or all of the shareholders of the company and the company which contains detailed provisions regarding the composition of the Board and management, financing of the company, restrictions on the transfer of shares, termination provisions and other matters. In the absence of a shareholders' agreement, many of these issues would either be governed by the company's charter documents and applicable corporate laws, which may not deal with the issues in a matter satisfactory to the shareholders, or address them at all. Both of these situations lead to unsatisfactory results when conflicts arise.

Shareholders' agreements are more typical in private companies that have a small number of shareholders and intend to stay private. They are less common in companies contemplating be

rescinded when the company goes public, as most of the restrictions are not suitable for a public company. Venture capitalists will, as a condition of making an investment in the company, typically require a form of shareholders' agreement and will often ask that their form replace any existing ones.

The main business points typically covered in a shareholders' agreement include:

- ***Contributions of the Shareholders*** - The agreement will spell out the existing share and loan contributions by the shareholders and will spell out any ongoing obligations to provide additional financing to the company. Most agreements will state that the company will try to obtain any new financing required from external sources but that if it is unable to do so, the shareholders must contribute to the financing pro rata in accordance with their holdings, and if they do not, their ownership interest will be diluted.

- ***Operation and Control of the Corporation*** - The agreement will contain provisions regarding the management of the company, including the right of a shareholder to have representation on the Board; shareholder approval requirements for certain specified material transactions affecting the company; and restrictions on the authority of directors.

- ***Restrictions on the Issue and Transfer of Shares*** - The agreement will usually provide that if the company wishes to issue shares, the shares must first be offered to existing shareholders pro rata in accordance with their holdings, so as to enable the existing shareholders to retain their existing percentage interests in the company. The agreement will also restrict any shareholder from transferring its shares unless they comply with the other provisions of the agreement. These provisions would include a requirement for the transferee to become a party to the agreement and require compliance with any right of first refusal provisions (see below).

- ***Rights of First Refusal*** - The agreement will typically provide that if a shareholder wishes to sell some or all of its shares, it must first offer those shares to the existing shareholders pro rata in accordance with their holdings. In this way, existing shareholders can avoid having an undesirable third party become a shareholder without their consent.

- ***Piggy Back Rights*** - A piggy back right is a provision which provides that if a shareholder is selling its shares to a third party, then the other shareholders will be entitled to require that the sale not be completed unless the third party also purchases their shares on the same terms. This right is particularly beneficial to minority shareholders where a majority shareholder wishes to sell control of the company.

- ***Purchase of Shares Following Death and Insurance*** - The agreement may provide that in the event of the death of a shareholder, the company or the other shareholders are obligated to purchase the shares of the deceased shareholder. As this could trigger a large financial obligation, the agreement would also provide that the company or its shareholders will purchase and maintain insurance on the lives of the other shareholders so that in the event of a death of a shareholder, their shares can be repurchased from the proceeds of the insurance.

- ***Buy-Sell or "Shot-Gun" Provisions*** - A buy-sell provision provides a mechanism by which shareholders may end their relationship with the company and the other shareholders. A typical buy-sell provision will provide that if a shareholder wishes to terminate the relationship, they must make an offer to the other shareholders. The other

shareholders may then elect to have their shares purchased at the offered price, or alternatively, to buy the offering shareholder's shares at the offered price. Giving the offeree shareholder the right to elect whether to buy or sell creates a strong incentive for the offering shareholder to offer a fair price.

Whether or not you should put in place a shareholders' agreement is really a question of preference. However, if your company is on the fast track to going public or in the midst of pursuing VC financing, we would not recommend putting one in place.

Financing Plan

Before approaching financiers, the company should have Financing Plan in place. A Financing Plan is a plan that integrates the company's funding needs with the prices at which it would ideally like to be selling its equity to raise this funding in the future. It should be noted that this will only be a plan as the financiers who will be approached will want to negotiate those prices. The purpose of implementing a Financing Plan is solely to give the company a starting point for these negotiations and a road map to follow. Without this, the company would be proceeding blindly.

To prepare a Financing Plan, undertake the following steps:

Step 1: Identify the funding needs for the next 12 to 24 months. Ensure that these are backed up by a budget, broken down monthly, set out in spreadsheet format. Make sure all the assumptions on which the budget was prepared are clearly stated and reasonable.

Step 2: To the extent possible, divide the funding requirements into two or three rounds or tranches. Ensure they are graduated starting small and increasing. Ideally, the first round would be in the $250,000 to $750,000 range, the second in the $1,000,000 to $3,000,000 range, and the third would finance the remainder and be largest round needed.

Step 3: Determine the developmental "milestones" that will be met with each round of financing with as much particularity as possible . One of the most important things a company can do to ensure that it will be able to continue to secure funding over several rounds is to identify the milestones it will meet with each round, meet those milestones within the time periods projected and be able to show, preferably by making comparisons to other companies, the value being built in the company as the milestones are being met.

Step 4: Determine the value of the company at each stage, using the value that you believe will be built in company as the milestones are met, and then the number of shares that should be offered at each round and the price at which they should be offered.

Step 5: Put this into tabular form for an overview of the company's capital structure as if the Financing Plan played out as anticipated.

One of the important points to note is that the Financing Plan is only a plan and it is extremely unlikely that it will play out exactly as anticipated. It is the perceived value of the company to an investor as it grows that will ultimately determine the price of each round of financing, and this matter will very much be a point of negotiation with the financiers. A company cannot simply keep increasing the price of each round of shares because it wants to. It has to be able to show its financiers that it has been hitting its milestones and that value is being built. If the company

cannot show this, it could conceivably sell subsequent rounds of shares at lower prices than preceding rounds or, in a worst case scenario, not be able to raise funding at all.

We further recommend that the initial round of financing (in the $250,000 to $750,000 range), be split into an initial $100,000 to be followed immediately by the remainder of that round. This initial $100,000 should be used to get the company incorporated, retain initial legal, accounting and tax advice, set up an office and secure phone and fax lines and email addresses, and prepare business cards, letterhead and an initial draft of a business plan. In other words, raise at least $100,000 initially for basic infrastructure.

This first $100,000 should come from the founders themselves, or from their close friends, relatives and business associates. The reason for this is that outside investors like to see the founders have their own cash in the company. If they cannot afford to do that, then the next best thing is for them to have "love" or "blood" money in from their friends and family. The reasoning for this is two-fold. First, outside investors do not want to fund the incorporation of the company, preparation of the initial draft of the business plan and the implementation of the basic infrastructure. They want to come in after those things have been done so that their funds are used for the development, marketing, manufacturing and distribution of the company's products and services. More importantly, they want to know that the founders will be accountable and the best insurance is to have the founders' own funds in the company or funds from people close to them.

It should be noted that financiers will not, under any circumstances, fund the company to pay out shareholder loans owing to the founders or their friends and family. Therefore, the initial $100,000 should come in as equity and not debt investment.

At this early stage in the company, it is typically very difficult to put a value on the company for the purposes of determining the price of the initial shares sold to raise this $100,000. However, a practice has developed to sell these shares at $0.25 per share so many companies choose that price. It is then up to the company to build value in order to justify increased share prices for the subsequent rounds. Because this $100,000 is often pulled out of the first $250,000 to $750,000 round, the balance of that round is often sold at the same price.

For a sample of a Financing Plan, let's assume that the company in question will need $5,000,000 as follows:

- $500,000 immediately,
- $1,500,000 in 180 days, and
- $3,000,000 by the end of the year to be used for the following year.

The first $500,000 will be divided into $100,000 to come from the founders and their friends and family, with the remaining $400,000 to come immediately thereafter.

With these parameters, the Financing Plan ***might*** look like the following:

Sample Financing Plan

Source	Shares	Price/Share	Total Consideration
Founders	6,000,000	$ 0.0001	$ 600
Friends and Family	400,000	$ 0.25	$ 100,000
Angels	1,200,000	$ 0.35	$ 420,000
Venture Capitalist	3,000,000	$ 0.50	$ 1,500,000
IPO	3,000,000	$ 1.00	$ 3,000,000
	13,600,000		$ 5,020,600

To the extent the company can build value with each round of financing, the company will hopefully be able to sell subsequent rounds at higher prices and thus suffer less dilution.

Stock Option Plan

The typical way to provide incentives to employees, Board members and advisory committee members is to grant them stock options. A stock option is the right to buy a set number of shares in the company for a period of time (usually several years) at a set price. The incentive to the option holder is to help the company grow such that its share price at the time the option is exercised is much higher than the exercise price of the options.

A Stock Option Plan is simply the company's overall plan as to how many options it will grant, in what manner and at what price. The plan will be contained in a formal written document that will set out the basic terms of the options.

Once the founders' shares have been allocated and the Financing Plan determined, we recommend putting in place a Stock Option Plan that will be used to provide incentives to senior officers, employees, consultants, directors and advisors.

For public companies listed on TSX Venture Exchange or the TSX, a Stock Option Plan for a start-up typically will not exceed 20% of the company's issued and outstanding share capital. Generally speaking, shareholder approval is required for the plan.

For private companies, there are no limits on plans other than practical ones. Outside investors want to see Stock Option Plans in place so that they know the employees will have an incentive to work to build the company. However, they also do not want the plan to be unreasonably large. In light of this, private companies typically put in place plans that are similar in size to public companies. If they vary from this formula, it is usually by being a little bit larger rather than smaller.

Public companies often refresh their plans regularly, sometimes once a year. While there is nothing stopping a private company from doing this, they often put in a slightly larger plan at the beginning but plan on leaving it in effect until the company goes public at which point it could then be refreshed.

As with the founders' shares, stock options granted to senior officers and employees will typically vest over two to four years. We recommend that stock options granted to any new senior officers, employees and consultants joining the organization have been in place for at least one year before any portion of the options vest. Thereafter, they should vest over the next one to three years, no more frequently than quarterly. Stock options to directors and advisors typically do not vest: the former, because it is the only compensation to directors and they assume liability immediately upon being appointed; the latter, because the number of options granted is typically very small. The following are some suggested guidelines for allocating your stock options:

Sample Stock Option Allocations

	Minimum	**Maximum**
Senior Officers (V.P. and above):	35%	50%
Employees (Levels 1, 2 and 3):	25%	35%
Board:	13%	20%
Advisors:	2%	5%
Contingency:	10%	15%

Note: Percentages refer to a number of options available

Preparing for Financing

Once you have laid the groundwork by proper initial corporate structuring and development of a Financing Plan, you are ready to finance your company. This Part provides guidelines on how to prepare your company to maximize your chances of successful financing. It explains how to approach financiers (such as angels, investment bankers, venture capitalists and underwriters) and identifies what materials need to be prepared for successful investor presentations.

Types of Financing

There are three main categories of financing: equity financing, debt financing, and in-kind financing.

Equity Financing

For a start-up company, the most common way to secure funding is to sell shares of the company to investors. This is called equity investment or financing. The term "equity" is sometimes used synonymously with the term "shares", although this is not technically correct.

In an equity investment, the investors pay an agreed upon price per share to purchase an agreed upon number of shares in the company. It is called equity investment because the investor actually owns a piece of the company (represented by the shares), as opposed to a lender who has loaned funds to the company and has only the rights under the security granted. While the lender expects to have his loan repaid at some point (thus severing his relationship with the company), the shareholder will not typically get his investment back from the company (unless the company is liquidated) and instead expects to get his money back, and hopefully more, by selling his shares to someone else who in turn will then own that piece of the company.

While the holder of shares in a company is ahead of a creditor or lender in that the shareholder actually owns a portion of the company, the holder is behind in some respects. Lenders and creditors usually get paid first before the shareholders should the company go into bankruptcy and be liquidated (its assets, property and business sold off). Lenders usually get their money back first because that's a provision of their security agreements. Creditors usually get their money back first because of creditor protection and corporate legislation.

Companies can have numerous classes of shares with different terms and conditions attached to each class (subject to limitations under corporate legislation). However, in most cases, companies have only one kind and class of shares outstanding, called common shares. When a company has only one class of shares outstanding, the corporate legislation that governs the company in question will typically prescribe certain basic rights that must attach to those shares. These usually include voting rights and the right to participate in the proceeds realized on a liquidation of the company, among other things.

Common Shares

When there is only this one class of shares in the company, every single shareholder has exactly the same rights and restrictions attached to his or her shares. The only difference between Shareholders is the number of rights (such as the number of votes or the number of dividends to which the shareholder is entitled) as it will be proportional to the number of shares each shareholder holds.

Preferred Shares

There is no one standard form of preferred share. The term preferred simply means that the particular class of shares has some preferential rights attached to it that puts the holders of those shares ahead of holders of other classes of shares such as the common shares. Usually the name attached to the class gives you some idea of the rights and restrictions attached:

- **Redeemable preferred shares**, meaning the shareholder can force the company to buy the shares back (some people mistakenly call this class "retractable", as the two terms are often confused).

- **Retractable preferred shares**, meaning the company can force the shareholder to sell the shares back to the company (some people call this class "redeemable").

- **Cumulative preferred shares**, meaning that if an annual dividend which is supposed to be paid isn't, then it will accrue and be paid in the future.

- **Multiple voting shares**, meaning that each share carries more than one vote in some, or all, circumstances.

- **Convertible preferred shares**, meaning that they are convertible into another class of shares, typically the common shares.

Corporate legislation defines some limits on what kinds of rights and restrictions may be attached to shares. Typically, preferred shares might give the holders the right to receive a certain prescribed rate of dividend before the holders of the common shares are entitled to receive any dividends, and the right to receive a return on their investment before the holders of the common shares receive any return should the company go into bankruptcy and be liquidated. For this reason, professional investors such as venture capitalists, will often require a certain form of preferred share be issued to them for their investment.

Debt Financing

Debt financing simply means financing by way of a loan. This is funding provided to the company by one or more lenders on the understanding that the company will repay the loans to the lenders at some point in the future. It is called debt financing because the lender, or creditor, does not actually own a piece of the company. Instead, the lender has typically provided funds to the company usually on very specific terms with respect to the interest that will be paid on the loan (this is the lender's upside), and with respect to when the loan will be repaid.

There are all kinds of debt financing but much of it falls into the following three categories: founders' debt, bank debt and third party or investment debt.

Founders' Debt

The founders, typically being the first shareholders of the company, will often loan money to the company, referred to as shareholder loans, in order to get the company going. This is very common when a company starts up and is also very common after even starts-up if it remains a private company. Companies that go public at least in part, in order to secure financing, are not typically funded by shareholders loans.

Bank Debt

Bank debt is essentially a loan provided by a bank to a company. There are all kinds of loans banks will make. A bank loan may be provided in the form of a fixed term loan for a specified amount, repayable on a specified day, or in the form of a revolving line of credit which may go up and down and which is only repayable if the company wants to repay it or if the bank calls on the loan.

Banks are often hesitant to loan money to a start-up venture because of the risks associated with start-ups, the overwhelming majority of which fail.

When banks provide loans, they ask for "security" to secure the loan. Security simply means documented agreements that provide the bank with a method to get its loan repaid should the company be unable to make the loan payments. A house mortgage is an example of a form of security.

Since an early-stage company typically has little in the way of assets which could be sold by the bank should the bank have to call its loan, the bank will often ask for security from not only the company but from its founding shareholders, as well. This could also take the form of personal security.

Third Party or Investment Debt

While some banks might be hesitant to loan money to a start-up, there are professional investors, such as finance houses, venture capitalists and investors, who are inclined to make higher risk loans than banks. While they might be prepared to make these types of loans, they will typically ask for at least as much security as a bank might have requested, and often more. These investors often want preferred shares for their investment, convertible into common shares, and will require the founders to enter into a Shareholders' Agreement with them. They will also demand a high rate of return for agreeing to provide high risk financing.

Depending upon the terms of the preferred shares, this investment may cease to be debt investment and instead constitute equity financing (see below). In the alternative, it may start out as debt, convertible into equity, such as common shares. Convertible preferred shares, convertible promissory notes and convertible debentures are all examples of debt instruments convertible into equity.

In-Kind Financing

In-kind financing is actually a type of equity financing, and essentially means that the company receives something other than cash in exchange for its shares. This could be almost anything, but most often consists of:

- Assets or property (such as computers, vehicles, software, intellectual property etc.) transferred to the company for shares.

- Labour and services (such as management services, legal, accounting, business consulting, incubation services etc.) provided to the company for shares.

It is an alternate form of financing since the company would otherwise have had to come up with the funds to pay for those assets and, if it did not have those funds, it would have had to have raised financing (probably by selling shares) to provide those funds.

Sweat Equity

The most common form of in-kind financing is the sweat equity put into a start-up company by its founders. Typically, when a new company is formed it has no funds in it unless the founders put some cash into it themselves. While they may put some funding into the company for shares, it is very common that they will purchase a large number of common shares (referred to as "founders' shares") at a very low price (usually no more than a penny per share and often much less) with the low price being recognition of the fact that the founders are spending a considerable portion of their time building the company without being paid for their time.

Sometimes in addition to these founders' shares, they will record the amount of time they spend on the business of the company and issue themselves shares, not at a low price but at a seed-financing price such as $0.25 per share, to pay for their time. While one would think that the founders should always do this, the reason it is not always done is that in many jurisdictions this

would constitute "income" for income in an amount equal to the number of shares the company issued for the services times the price per share and could be taxable. For this reason, founders usually only take shares at these higher prices to reimburse themselves for expenses which they personally paid on behalf of the company which would not constitute income to them.

Property

A more common kind of in-kind payment for shares consists of assets or property transferred to the company in exchange for shares. An example would be a patent on a medical device, developed by an individual on his own time at home. If he spent a year developing it and several hundred hours of development time and If it would cost the company $50,000 or $100,000 to develop the device on its own, it might instead buy the device from the developer for $50,000 worth of shares of the company.

Similarly, the founders might transfer physical assets (known as hard assets) to the company in exchange for shares. This could include office furniture, computers, hardware, vehicles or any other asset the company might need.

These asset transfers may also have tax consequences, and tax advisors should be consulted before they are undertaken.

Other In-Kind Services

As well as the sweat equity put in by the founders, the company may decide to retain other professionals and pay them with shares instead of cash. It is not uncommon for start-ups to pay their lawyers partially in shares, accountants (but not auditors who must remain independent), business consultants, incubators and even their landlords. The hesitation that these third party service providers might have in taking shares for their services is a tax problem they might face. In many jurisdictions, the shares will be treated as "income" for income tax purposes and, of course, they will not have received any cash to pay for the taxes payable on that income.

Seed Financing Overview

There are various stages that a company will typically go through as it finances. The term seed financing has no official meaning and simply means the initial (pre-public) financing that a company might secure. While there is no set route, the following is a typical path that the company might follow and the sources of financing it might pursue:

- A company in financing mode will typically start with an initial round of seed financing which comes from the founders or a group close to them (such as friends and family).

- After the initial round of seed financing has been completed or, more typically, exhausted, the company may look to outside investors (financiers including angels, venture capitalists, investment bankers or underwriters) for its follow-on financing needs. While this investment will involve outside financiers, it is still considered "pre-public" financing because it doesn't usually include a solicitation of the general public at large to invest.

After the initial and follow-on rounds of financing have been completed, the company may look to the public markets for financing and go public.

Preparing the Pitch

Generally, when seeking financing, you will only have one opportunity to make your pitch. Therefore, you want to be well prepared when the opportunity arises. While the materials to be provided to financiers and investors will depend somewhat on which type of financier or investor the company is approaching, the investor package will usually consist of the following:

- **A detailed Business Plan**, subject to the caveat noted below. The company may have more than one version of its Business Plan. This is not the operational version, nor the Strategic Plan. This version should be prepared specifically for financiers and investors and should focus on the company's funding requirements and the milestones it will meet with its funding.

- **An Executive Summary of the Business Plan**, subject to the caveat noted below. This is really a part of the Business Plan which will appear at the beginning of the plan as the first section following the table of contents. However, it should be capable of standing on its own so that it can also be handed out separately.

- **A Investor (Power Point) Presentation**. This usually consists of no more than 10 to 12 slides on the business of the company. Like the Business Plan, the company will have more than one Power Point presentation. The one for investors will be quite different then the one for strategic partners and the one for customers. The one for investors will focus a little less on the business and instead will include something on the investment opportunity.

- **An Elevator Pitch**. The Power Point presentation should be accompanied by a 20 to 30 minute verbal presentation. The Elevator Pitch is the shortened version of this verbal presentation, a snapshot that captures the "sizzle" of the company of minutes. It might be used to introduce the Power Point presentation.

Please note that the securities laws of certain jurisdictions may prohibit you from providing your Business Plan and Executive Summary to certain potential investors. You should consult with your legal advisor first to determine whether or not it would be permissible to provide these documents to a particular potential investor before doing so.

The Essence of the Pitch

The essence of the pitch to financiers and investors is to answer the following basic questions:

- What product/service does your company provide or propose to provide? Is it ready to sell now and if not, when? If it is being sold now, what are the company's revenues to date?

- Who comprises your management team? What is their relevant experience? Who will fill which roles?

- Who is going to buy your company's products/services and why will they buy them? Who are your competitors and why are you better than them? What are the barriers to entry?

- How will your company make money from selling its product/services? What evidence do you have that the market will pay your asking price for your products/services? How big is the market opportunity?

- How much money do you need and what are you going to do with it? More specifically, what milestones are you going to meet with these funds and by when? What comparables can you make to demonstrate an increase in value in your company when you hit those milestones?

The answers to these questions should form the core of the company's investor presentation. You should focus on answering these questions clearly and concisely in your materials. The mistake many companies make is providing way too much technical information to financiers and investors while failing to provide them with the core information they really want. You want to catch their attention in the first meeting so that they will invite you back to fill in the gaps. All of the technical information can be fleshed out in the due diligence period if the financier or investor decides to go ahead. In the initial stages, it is important not to get lost in the details.

Financing Sources

Aside from founders and their families and friends, financing comes from four main sources: angels, investment/merchant bankers, venture capitalists and underwriters. In addition to these four sources, financing has also started to come more frequently from strategic partners. The following is an introduction to these financing sources.

Angels

The term "angel" has no official meaning. It loosely describes wealthy individuals who are not professional investors (although that has changed in recent years especially in the US) who want to invest both to make money but also to support start-up companies and their entrepreneurs. Angels are also often interested in working with those entrepreneurs to help them launch their companies. They are referred to as “angels” because they are considered "friendly" and "smart" (they offer their expertise to management). Unlike venture capitalists, angels do not typically impose formal controls over management.

There are no hard and fast guidelines as to how much an angel will invest and in what form, but most seem to invest, individually, somewhere between $25,000 and $150,000, and may invest as much as $500,000. More likely than securing a large investment from a single angel, “an angel round” might consist of financing from three or four angels who together invest up to $500,000.

Ideally, a company will find two or three angels with expertise that the founders of the company could use. The founders would secure the investment from the angels and then use the angels, possibly as formally appointed to the Board or as Advisors and in some cases, as interim management, to help them build the company.

Investment/Merchant Bankers

The terms investment banker and merchant banker have different meanings depending upon where you are. In the east and in the U.S., merchant bankers are typically professional investors who invest their own funds in a deal. Similarly, investment bankers are individuals employed by a brokerage firm that manage funds provided by the clients of the firm. Vancouver does not have a large number of true merchant bankers and many of its investment bankers simply refer to themselves as brokers.

The Vancouver market is unusual in that so much of the financing raised is venture capital. Senior brokerage firms are often like banks and hesitant to invest in start-ups because of the considerable risk associated with them. As a result, a community of small venture capital funds and private investors have sprung up to fill the void. These are investors who tend to be less adverse to risk.

The ones who have raised fund from outside investors typically refer to themselves as “venture capitalists”. There are others, however, who may invest their own funds and the funds of a close group of their business associates. They do not raise a fund; instead, they put together a syndicate of investors who will look at each deal that they do and choose how much they want to invest or if they want to invest at all. They will also introduce these companies to brokerage firms which they maintain close ties, so the company can go public at some point. They might invest privately in the first round, and then help organize a private placement, initial public offering or reverse takeover of the company as the second round and third rounds of investment.

There is no one name these individuals. Some simply refer to themselves as businessmen or women. However, many refer to themselves as investment bankers, for lack of a better title. They often operate in small firms of two or three partners. These firms typically have something like "Capital Corp." in their firm names.

Similarly, there is no set formula for how these investment bankers operate. They will approach each deal on its own merits and their decision to invest and to introduce outside investment will depend upon how much they like the deal and whether or not they can be properly compensated. In many cases, they will ask the existing founders to sell them some of their founders’ shares, or to grant them an option to buy some of their founders’ shares at nominal consideration. The rationale is that they become quasi-founders whose responsibility it is to raise financing (sometimes more than one round) for the company and to guide the company to a public listing. These investment bankers will often take a Board seat and they can be very helpful to a company that does not have any management with financing experience.

Typically, they can raise funds in the $1,000,000 to $2,500,000 range themselves, and can introduce other financiers to raise up to $10,000,000 in a subsequent round.

The advantage of working with an investment banker is that you find a partner who will become responsible for the company's corporate finance needs and strategy. Also, unlike venture capitalists, investment bankers will not exact much in the way of control over management other than to act as Board members and to monitor the use of the funds raised. On the other side, however, by bringing on an investment banker and the investment from a small number of his or her business associates, the founders must be sure certain they can work with these individuals and that they trust them because the size of their investment will make them a business partner to be reckoned with.

Venture Capitalists

Venture capitalists or VCs are firms who have raised an investment fund and are responsible for investing those funds and managing the investment. The fund may have been raised privately or publicly. The objective of the VCs is to invest the fund and realize a return for the people who invested in the fund. VC are professional and very sophisticated investors.

In Vancouver, there are only about a half a dozen major players in the VC market. Recently, a number of smaller venture capital firms have sprung up. With Vancouver's technology community growing rapidly, it is expected that the major VCs will continue to grow and that new smaller VCs will continue to enter the market.

VCs typically do not want to invest at the angel stage or in amounts of less than $500,000 to $1,000,000, with $1,000,000 to $3,000,000 being their sweet spot in the Vancouver market. They often like to syndicate their investment with one other VC and rarely with more than two others. They often prefer companies that have already completed the friends and family round and possibly an angel round. They are less inclined to participate in a deal which has professional investment bankers already involved, feeling that their roles will be redundant. Notwithstanding the foregoing, with any astute investor exceptions, will be made for the right deal.

One of the biggest advantages in dealing with a VC is that they actually have the funds to invest on hand. Once they have completed their due diligence to their satisfaction, negotiated a fair valuation for the company and the financing agreements, they can usually cut the cheque very quickly. Unlike investment bankers and underwriters who may look to their business associates or clients to put up the funds, the VC actually has the funds. With investment bankers and underwriters, they may sometimes be in raising funds no matter how much they like the deal.

The biggest disadvantage of VCs is that they have very strict rules for their investments and they will require that management give up a fair amount of control over the company. They will also want their investment secured similar to a bank, although the security might be in the form of preferred shares rather than mortgages and debentures. While each deal will be different, examples of some of the things VCs might ask for are as follows:

- A preferred share that is convertible into common shares at the VCs election. While the preferred shares are outstanding, they will take priority over the other shares in the event the company is liquidated.
- Should certain events occur such as the management team departing the company or the company changing it business focus, the right to redeem its investment with a premium paid back.
- Each Founder to have his or her founders' Stock tied up so that they cannot sell. Also, vesting provisions so that some of their founders' shares are cancelled if the Founder leaves the company.
- Each Founder to have entered into an employment agreement which will include confidentiality provisions and non-competition provisions should the Founder leave.
- A Board seat or two and the right to approve all other Board members.
- The right to approve all future financings and a right of first refusal to provide all future financings.
- The right to approve all major transactions.

- An option or warrant to buy shares or the right to receive additional shares should the company need to undertake a down round of financing subsequent to the VC round, meaning a round at less than the price of the VC round.

These rights and restrictions will be set forth in a number of agreements entered into with the VCs including a Shareholders' Agreement and an Investment Agreement, among others.

While these restrictions may seem extreme to some entrepreneurs, VCs argue that not only are they necessary in order for them to secure their investment but that they also constitute a good discipline for the company. They will note that once the company has agreed to the terms it is guaranteed to receive its funding. Further, they will note that they will be able to provide subsequent rounds of funding, introduce the company to US VCs if appropriate, and introduce the company to underwriters when it is time to go public. The will argue that all of this is value add that other investors simply can't bring to the table.

Much like investment bankers, once the founders have taken on a VC they have a partner to be reckoned with.

Underwriters

In B.C., in order to be an underwriter, you must be registered as such under the. Securities Act (British Columbia). This is the same in most other provinces as well. As a result, most underwriters are registered brokerage houses or firms. Their role is to take your company public by raising money through an initial public offering, or "IPO".

In B.C., an IPO may be undertaken to raise as little as $1.0 M, and most IPOs are in the $1.0 M to $5.0 M range. By comparison, an IPO in Toronto would typically be at least $10M to $15M or more and, in the U.S., at least U.S.$25M or more.

Prior to undertaking your IPO, your underwriter might also provide some seed financing. It is extremely unlikely that an underwriter would provide seed financing without an agreement on the part of the company to go public.

An underwriter might also be referred to as an agent, broker or sponsor. The latter refers to the underwriter's role in sponsoring the company's application to list on a stock exchange on the completion of the IPO.

Strategic Partners

Another source of financing for companies that has become much more common in recent years is strategic partner financing. This is financing provided to a start-up company by a larger, more established company, where some other kind of commercial relationship has been established between the two companies. The larger company may provide cash to the start-up or make its investment in-kind, providing goods and services in exchange for shares. Also, the larger company may provide cash but then require the start-up to use a portion of it to pay for services the larger company will provide over time to the start-up.

Financing Through Business Structure

This section provides some additional financing options which arise as a result of unique corporate structuring.

Venture Capital Corporations

The *Small Business Venture Capital Act*, RSBC 1996, c. 429 (the "Venture Capital Act") is legislation whose purpose is to promote investment by arm's length parties in small B.C.-based businesses. As an incentive, investors are entitled to a tax credit equal to 30% of their investment. Investors may use this credit to reduce their British Columbia income tax, or, if the investor is an individual, they may have any portion of the credit that they did not use in the taxation year refunded in the form of cash. If the investor is a company, it may not obtain a cash refund, however, it may carry forward any unused portion of the credit for four taxation years.

Investments under the *Venture Capital Act* can be made directly into your company or through a venture capital corporation ("VCC"). In order to use the direct investment model or be registered as a VCC, and thereby, entitle investors to qualify for the tax credit, a company must meet the strict requirements of the Venture Capital Act.

For information on the VCC program, refer to the B.C. government's Business Equity Programs page at www.cse.gov.bc.ca/subwebs/business/beb/default.htm.

Employee Share Ownership Program

B.C.'s Employee Share Ownership program provides employees with a 20 percent tax credit for making investments in their employer's businesses. In most cases, investments can also be transferred to self-directed RRSPs to obtain further tax benefits. Already an extremely cost-effective way to develop employee participation, the program is available to both privately held and publicly trade companies. For details about this program, visit the B.C. Government's Business Equity Programs page at www.cse.gov.bc.ca/subwebs/business/beb/default.htm.

Limited Partnerships

Limited partnerships are entities created by statute and in British Columbia are governed by the Partnership Act, RSBC 1996, c. 312 (the "Partnership Act"). A limited partnership consists of one or more general partners (who run the business) and one or more "silent" limited partners (the investors) who carry on business together with a common view to profit. One advantage of a limited partnership is that the liability of each of the limited partners is limited to the amount invested by such limited partner in the business. However, in order to retain limited liability, a limited partner must not participate in the management of the business of the partnership and the Partnership Act provides some guidance as to what may be considered taking part in the management of the business of the partnership.

Limited partnerships can be attractive vehicles for businesses with large start-up losses and for investors who wish to reduce their income from other sources because the income and the losses of the partnership business are flowed through to the partners as the limited partnership itself is not a taxable entity. Investments in a limited partnership are entitled to deduct their share of partnership losses up to their "at risk" amount.

Government Assistance

Both levels of government provide a variety of programs to assist businesses in raising venture capital. A detailed listing of the numerous government programs is beyond the scope of this paper. Readers are referred to the following websites:

Federal Programs: www.strategic.ic.gc.ca/SSG/so01884e.html

B.C. Government Programs: www.gov.bc.ca/cse

ADDITIONAL READINGS AND RESOURCES

National Research Council: www.nrc.ca

Science Council of British Columbia: www.scbc.org

T-Net British Columbia: www.bctechnology.com. Click on "Financing" at the home page.

Vancouver Enterprise Forum: www.vef.org