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Acredula

Bricker & Eckler LLP
100 South Third Street
Columbus, Ohio 43215-4291
(614) 227-2300
FAX (614) 227-2390

info@bricker.com
www.bricker.com
www.BoardandExecutive.net

Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Liquidity Events Require Both Planning and Protection

Editor's Note

John P. Beavers
Partner,
Bricker & Eckler LLP

More businesses, both emerging and established, are looking for a liquidity event in order to either finance their development and growth or to provide liquidity to their owners. In the next two issues of *Acredula*, we will address the concerns of these businesses by focusing on raising venture capital. The two-part series appearing in the February and March issues will highlight strategies for planning a merger or acquisition.

Before any form of liquidity event occurs, a business must complete two requisite steps: The business must plan its preparation for the event and, as part of that plan, must protect its own resources. This issue's feature article focuses on the planning and protection that are necessary before seeking venture capital. Next month's issue will focus on structuring the venture capital deal as part of that plan.

Raising Capital to Develop Your Venture's Operations

Part I: Planning Business Development and Protecting Resources

John P. Beavers and Thomas R. Brownlee, Jr.

In this two-part series, we will address the guidelines for raising capital in order to commence a venture's operations. This first installment focuses on the preliminary steps to raising capital: planning the development of your business and protecting the resources of your venture. Unless you have a successful track record of starting businesses, you should complete these two important requisite steps.

Planning the Development of Your Venture's Business

A business plan has two purposes. One is to plan the development of your venture's business so you can assess its development and make changes in an orderly fashion. The other is to describe your business, its development to date, and your plans for future development so that potential investors and other providers of capital, such as banks and lending institutions, can determine whether to provide such capital.

A business plan has several key sections, including the business description, management expertise and experience, security ownership, management's discussion and analysis of the plan of operation, financial statements and projected financial information, which are discussed in the paragraphs below. Securities and Exchange Commission (SEC) Regulation S-B provides helpful guidelines detailing the issues to consider for each of these sections. Regulation S-B is available on the SEC's Internet website, www.SEC.gov, under Small Business Information, Small Business Forms and Associated Regulations. The direct Internet address to Regulation S-B is www.sec.gov/smbus/forms/regsb.htm.

John P. Beavers
Partner,
Bricker & Eckler LLP

Thomas R. Brownlee, Jr.
Partner,
Bricker & Eckler LLP

Business description. For guidelines, see item 101 of Regulation S-B. A business description typically includes summaries of:

- Your products or services and the stage of their development;
- The potential clients or customers for those products or services;
- The markets of those potential clients or customers and the size of those markets, both geographically, if relevant, and financially, including potential sales;
- Your competitors and how customers or clients will distinguish your products or services from theirs; and
- The principal properties, both physical and intellectual, of your business and, to the extent relevant, their location and capacity.

Management expertise and experience. For guidelines, see item 401 of Regulation S-B. To the extent that your business plan is intended for potential investors and other providers of capital, such as banks and lending institutions, it should describe the expertise or competencies each member of the management team brings to your venture and their experience in providing those skills to similar ventures and other businesses. For most investors and other providers of capital, experience is more important than any education, degree or certification obtained, and only the most recent five years of experience are relevant. Investors and other providers of capital attach importance to the extent members of the management team are obligated to the venture pursuant to employment, confidentiality, and non-competition agreements.

Security ownership. For guidelines, see item 403 of Regulation S-B. This section should identify and describe the ownership of each owner of five percent or more of each class of equity securities as well as the ownership of management.

Management's discussion and analysis of the plan of operation. For guidelines, see item 303 of Regulation S-B. This section should discuss both the needs for and sources of capital for the ensuing years. Needs typically discussed are product research and development, acquisition or expansion of plant and equipment, and attraction or retention of key personnel. Sources of capital should include:

- Internal sources, such as those from operations; and
- External sources, such as those from debt, including borrowing, and those from equity, including sale of securities.

Financial statements. For guidelines, see item 310 of Regulation S-B. At the very least, these should include a balance sheet for the end of the most recent fiscal year and statements of revenue and expense, cash flow, and changes in stockholders' equity for the fiscal year then ended. If your venture has not yet completed its first fiscal year, the financial statements should include a balance sheet as of the most recent practicable date.

Projected financial information. The projected financial information should include:

- Statements of revenue and expense, cash flow, and changes in stockholders' equity for at least the next three years with monthly detail for at least the first year; and
- A balance sheet as of the most recent practicable date and projected balance sheets for the end of each year covered by statements of revenue and expense, cash flow, and changes in stockholders' equity.

Protecting Your Venture's Resources

Investors and other providers of capital will generally require that your venture's resources are protected for the venture as a condition to their providing capital. The two most important resources are the human resources of your management team and other key personnel and the intellectual property of your business, products, and services.

Employment terms. With respect to the human resources, investors and other providers of capital typically want key members of management and other key personnel obligated to the venture through employment contracts. Two of the most important provisions of an employment contract are:

- ***Notice provisions***, which require an employee to give advance notice (typically 30 days to six months) before resigning or quitting; and
- ***Discharge provisions***, which authorize someone, typically the board with respect to the CEO and the CEO or the board with respect to any other officer or employee, to remove an individual from his or her authority and responsibilities as an officer and employee, with or without cause.

Often these notice and discharge provisions provide different levels of compensation through either continuation of salary and bonus or payment of separate severance benefits if there is cause for discharge or good reason for quitting.

Restrictive covenants. Other provisions, typically referred to as "restrictive covenants," are also important to investors and other providers of capital. The most common of these covenants place restrictions on:

- ***Outside activities.*** These provisions are typically provided either in the affirmative, requiring employment "on a full-time basis," or in the negative, prohibiting any other employment or activity that impairs the person's ability to exercise his or her authority and to meet his or her responsibilities fully.
- ***Ideas developed.*** Usually an affirmative covenant, this provision states that any idea or invention developed by the employee for the business of the venture belongs to the venture and often includes an assignment of any such ideas, including inventions, to the venture.
- ***Use of confidential information.*** Typically a negative covenant, this provision prevents the use of business or trade secrets and other confidential information, except as authorized, in the course of the venture's business.
- ***Solicitations of resources.*** These provisions are generally a negative covenant prohibiting the solicitation of any employee, customer or client, vender or supplier, or similar resources of your venture to cease their relations with your business.
- ***Competition with business.*** Typically a negative covenant, this provision prevents competition with the business of your venture during, and often for a period after, employment.

Third-party nondisclosure agreements. In addition to protecting the human resources of your management team and other key personnel, your venture needs to protect its business and trade secrets and other confidential information, including technology and inventions. In addition to affirmative covenants and assignment by employees of ideas or inventions developed for the business of the venture as discussed above, third parties, including potential investors and other providers of capital, should sign a nondisclosure agreement before being given access to any such business or trade secrets and confidential information. Access to the business plan itself should require signing such a nondisclosure agreement.

Trademark, trade name, and domain name protection. Investors and other providers of capital will require your venture to protect its entity name, often including exclusive rights to an Internet domain name identifying your venture, as well as trade and service mark protection of your business' products or services.

Raising Early Stage Seed Capital

Typically, venture capital is not available until your venture is ready to begin marketing your business' products or services. This means you have developed a business plan, protected your resources, and developed your products or services to the point of commercialization.

Entrepreneurs generally have to fund development of the venture's business plan and protection of its resources with their own funds or those of family and friends.

Only a few venture capital firms provide early stage seed capital. This capital is typically not available until your venture is ready to begin development of the products or services of your business. However, even this early stage seed capital is not available until your venture's business plan is complete and its resources are protected.

The most common source for financing the development of products or services to the point of commercialization is "angel investors" – investors who either understand your products or services or have the utmost confidence in the management team and are willing and able to assume the risk of investing at this stage in your venture in return for whatever potential return your venture offers.

There are several ways to find angel investors. One is through advisory boards such as *Business First's* Advisory Board Exchange, which matches businesses with potential advisors, including advisors with knowledge of the angel and venture capital communities. You may contact *Business First's* Advisory Board Exchange by calling 614-461-4040 or by visiting its website at www.advisoryboardexchange.com.

Angel investors may also be found through a service, such as OhioAngels.com, that serves as a portal linking potential angels to Ohio entrepreneurs. You may contact OhioAngels by calling 614-262-5568 or visiting www.ohioangels.com. Another source of angel investors is through small capital investment bankers, such as Hellston Capital Group (614-262-5543).

Sources of venture capital include CID Equity Partners (614-222-8185 or www.cidequity.com), Ohio Partners (614-621-1210 or ohiopartners.com), OnVentures LLC (614-224-4878 or onventures.com), NCT Ventures LLC (614-659-8629 or www.nctventures.com), and Stonehenge Partners, Inc. (614-217-1111 or www.stonehengepartners.com). Groups that facilitate entrepreneurs presenting their plans before potential capital sources include Columbus Venture Network (614-225-6060) and Innovest (216-229-9445 or www.innovest.org).

A Caution about Securities Laws

Although your venture's initial resources will probably be limited, you must comply with federal and state securities laws when issuing securities, including either equity, such as stock, or debt, such as notes or debentures. If your venture fails to comply with these securities laws, purchasers of your venture's securities will have a rescission right that can force your venture to refund the entire purchase price of the securities. In addition, your venture, as well as you and persons who control your venture, may also be subject to civil and criminal liability. Although exemptions are available to avoid the costly registration provisions of federal and state securities laws, any offering of securities must be carefully designed from the beginning to take into account both past sales and possible future offerings. Accordingly, any venture should consult with competent legal counsel ***before*** any offering or any sale of securities.

Conclusion

Planning the development of your business and protecting its resources are essential steps on the road to raising capital. Early stage seed capital is easier to obtain if your business has completed these two preliminary steps, in addition to developing its products and services to the point of commercialization. Next month's installment will focus on presenting your business to venture capital firms and the structure of venture capital financing.

Counsel for
BOARDS AND EXECUTIVES
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John P. Beavers, Chair
(614) 227-2361
jbeavers@bricker.com

Jerry O. Allen
(614) 227-8834
jallen@bricker.com

Laurie A. Briggs
(614) 227-2355
lbriggs@bricker.com

Thomas R. Brownlee, Jr.
(614) 227-2301
bbrownlee@bricker.com

John W. Cook, III
(614) 227-2383
jcook@bricker.com

Michael E. Flowers
614) 227-2340
mflowers@bricker.com

James F. Flynn
(614) 227-8855
jflynn@bricker.com

Michael K. Gire
(614) 227-2318
mgire@bricker.com

Hope M. Goings
(614) 227-2360
hgoings@bricker.com

Steven R. Kerber
(614) 227-2356
skerber@bricker.com

Quintin F. Lindsmith
(614) 227-8802
qlindsmith@bricker.com

Gordon F. Litt
(614) 227-2305
glitt@bricker.com

Mark C. Pomeroy
(614) 227-2326
mpomeroy@bricker.com

Christine M. Poth
(614) 227-2395
cpoth@bricker.com

Richard D. Rogovin
(614) 227-2352
rrogovin@bricker.com

James A. Rutledge
(614) 227-8830
jrutledge@bricker.com

David C. Spialter
(614) 227-2342
dspialter@bricker.com

Michael F. Sullivan
(614) 227-2337
msullivan@bricker.com

Betsy A. Swift
(614) 227-8850
bswift@bricker.com

Kurtis A. Tunnell
(614) 227-8837
ktunnell@bricker.com

Faith M. Williams
(614) 227-2374
fwilliams@bricker.com

Randolph C. Wiseman
(614) 227-2310
rwiseman@bricker.com