Angel Capital Association

Corporate Governance for Startups: 
*A Guide for Growing Companies*

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Agenda:

- Introductions

- Corporate governance considerations for growing companies from the accounting, legal, and experienced angel investor perspectives:
  - At Close of Initial Angel Funding
  - Expansion, Raising Series B Round
  - Preparation for Exit

- Q/A

Speakers:

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Founder / Manager, Ohio TechAngels

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During the last 7 ½ years the Ohio TechAngel Funds(OTAF) have made 54 investments in 34 start-ups ventures; Its 282 members are from across Ohio. John has personally invested in 40+ technology ventures and is currently a Director of four OTAF portfolio companies.

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Cooley's 650 attorneys have an entrepreneurial spirit and deep, substantive experience, and are committed to solving clients' most challenging legal matters. The firm represents clients across a broad array of dynamic industry sectors, including technology, life sciences, venture capital, clean energy, real estate and retail. We have full-service offices in major business and technology centers across the United States: Palo Alto, CA, New York, NY, San Diego, CA, San Francisco, CA, Boston, MA, Broomfield, CO, Washington, DC, Boston, MA and Seattle, WA.

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PwC is a network of firms in 158 countries with 169,000 people who are committed to delivering quality in assurance, tax and advisory services. Anne-Marie has experience providing technical advice to both emerging and large multinational public companies on a wide variety of accounting and reporting matters, including those ranging from complex equity transactions, business combinations, and revenue recognition.

December 2011:

“Amazing Inc completes its first fundraising effort & closes on $1M from angels”
The Board’s Three Main Tasks:

1) Never, never, never run out of cash!

2) Mentor, Fire & Replace the CEO

3) Sell the company

What Angel Directors Should Know

- Directors Three Main Tasks/Responsibilities
- Duty of Care & Duty of Loyalty
- Directors’ Options (Forward Exercise of NSOs?)
- D & O policy nuances
- Legal structure implications (LLC vs. QSBS)
- The “Numbers”
“The Numbers”

- AICPA SOP 97-2  
  Software rev. recognition
- FAS 123R  
  Accounting for options
- IRC Sec. 83B  
  File w/in 30 days of options
- IRC Sec. 409A  
  Annual valuation of options
- IRC 1045  
  60 day tax free rollover of gains
- IRC Sec. 1202  
  100% capital gains exclusion
- IRC Sec. 1244  
  Loss against ordinary income

First Board Meeting

- Fully close Series A (Key Man/P & C insurance; Employment Agreements)
- Commence clean books & records
- Discuss plan to recruit Independent Director
- Discuss D & O Policy nuances; add Directors Indemnification Agreements
- Discuss Option Plan; Forward Exercise; 409A & 83b
- Interest Bearing Bank Accounts? Avoid Depository Risk!
- Follow Roberts Rules of Order!
Every Board Meeting

- Keep discussion at strategic level, avoiding tactics
- CEO reports on market transactions of competitors and Targeted Strategic Bidders
- Building *buyers value* is always discussed
- Executive session to discuss CEO’s performance?
- “Never run out of cash”
  - Cash in bank; Current burn rate & MTF (“Months to Fumes”)
  - Survival Cash Flow Break Even?
  - Update Capital Access Plan for next round

Overview

- Corporate Governance defined – “The set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled.” (Wikipedia)
- For a public company, primary drivers are laws and regulations – Sarbanes-Oxley, Dodd-Frank, other SEC rules
- For a private company, Delaware law, local state laws such as California, accounting rules and some SEC rules are still important
- However, the right processes and policies are of equal or greater importance
- Many companies just “get going” – expect accountants and lawyers to set accounting and legal limits and assume the right practices will just develop (i.e., whatever was done at CEO’s last start-up)
Process Goals

• Processes that help the organization grow and be successful while protecting interests of stakeholders
• As an investor, be specific and articulate what you want, and understand what is really happening at the company
• Evolve procedures over time in light of changes in business and growth in team
• Remain nimble and efficient, small companies have a massive advantage in this area over big ones, can’t squander it

Board Processes for New Hires/Options

• Determine overall grant guidelines for positions, based on industry, company size
• Determine policy re accelerated vesting for executives
• Determine desire of board to interview or be informed of key hires
• Pricing process – use of and frequency of 409A valuation
• Approval process – Board meeting / compensation committee/UWC
First Board Meeting

- Spending money [Establish signature authority and investment policies]
- Board education and management
  - Keep meetings short and effective
    - Distribute slides several days in advance
    - Don’t cover everything
    - CEO orientation – highlights and lowlights, key decisions needed, changes in direction
    - Agree on format / waterfall slides, sales pipelines
    - Use full management team sparingly
  - Communicate between meetings, particularly for those very “hands on” directors
  - Managing a Board is unique, not a conventional corporate hierarchy, but a “camp” from an anthropological point of view

Core Responsibility

- Set the appropriate “tone from the top”
- Oversee key financial reporting
  - Reliability of financial statements
  - Compliance with laws and regulations
- Ask questions of management and set expectations
Basic Considerations

- Controls
  - cash, investments and bank accounts
  - expenditures
- Tracking of equity instruments
- Evidence underlying transactions
- Estimated fair value of common stock
  - Not just used for 409A, it supports amounts recorded in financial statements
- If an audit is pursued...
  - development stage enterprise and reporting

June 2012:

“Amazing Inc continues to grow and is raising a $5M Series B.”
Preparing for the Series B

- CEO performance review by Compensation Committee
- Update 409(a) options valuation study?
- VCs will want an audit (Audit Committee in place?)
- Review/renew D & O policy; Directors Indemnification Agreements?
- Review Directors’ performance and option vesting; move anyone to Observer status?

Presuming a $5 million VC-led Series B

- Calculate the impact of dilution on CEO’s exit pay day
- Discuss refreshing the option pool
- Will all Directors participate in this round?
- Which current investors will participate?
- Will we ask them to commit before we select the lead VC?
- Should the CEO or a Director drive the VC selection process?
- Who will complete the VC questionnaire?
Financing

- Everyone has a “conflict” as well as common interests
  - Investors diluted / may not be able to participate
  - CEO worried about dilution / control
- Clear discussions on strategy / timing, fallback (noting that never “final”)
- Investors – be as open as you can re ability to fund
- Development of talking points / pitch
- Joint development of VC targets
- CEO/CFO should lead, with investor support
- Documents to prepare in advance
  - Previous term sheet
  - Cap table, with reasonable future pool
  - Online dataroom, becoming standard and affordable
  - Expected terms for internal use, sometimes externally

Approving the Financing

- Build history of full diligence, review of all alternatives (even if up round)
- Document details of interested directors (includes outside directors that later participate)
- Consider formal process / committee if you have independent directors
- Focus on disclosure schedules, don’t hide big bad news, or even minor information, from new investors
- If a wash-out, proceed carefully with refresh grants
Auditors Engaged --- Your Role

- It is not just for public companies…
  - Assessing completeness and consistency of financial statements
  - Risks of material misstatements and fraud are adequately addressed
  - Drive the selection, oversight, and evaluation of external auditors
  - Ensure external auditors’ independence
  - Review and understand the external audit scope, including materiality thresholds
  - Meet privately with external auditors on a regular basis and hold substantive discussions on the quality of the company’s financial reporting and significant accounting or auditing issues

What to Expect from the Auditors

- Required communications
  - Auditor’s responsibility under Generally Accepted Auditing Standards
  - Significant accounting policies, including critical accounting policies and alternative treatments within generally accepted accounting principles, and the auditor’s judgment about the quality of accounting policies
  - Management’s judgments and accounting estimates
  - Audit adjustments
  - Potential effect on the financial statements of any significant risks and exposures
  - Material uncertainties related to events and conditions that may cast doubt on the ability to continue as a going concern
  - Significant deficiencies and material weaknesses
  - Other information in documents containing audited financial information
  - Disagreements with Management
  - Consultations with other accountants
  - Significant difficulties encountered during the audit
  - Fraud and illegal acts
  - Other material written communications (copy of management representation letter)
Questions to Ask the Auditors

- What were the nature and extent of audit adjustments?
- Are there any internal control recommendations?
- Were underlying records readily available?
- Are reconciliations timely performed for key accounts?
- Are credit cards used by management for company transactions?
- What specific management representations did you require and why?
- Where is judgment exercised in recognizing revenue?
- In what area did you spend most of your time?
- Where was there significant discussion with management over accounting and auditing matters?
- Where is there a risk of fraud?
- What analysis was performed to conclude a going concern paragraph in the opinion was required or not?

Expansion to Foreign Territories

- Oversight by management
- Flow of information to parent company and accuracy of data
- Foreign Corrupt Practices Act (FCPA) considerations
- Tax considerations
  - Transfer pricing
Significant Revenue Growth

Those charged with governance should understand:

- Revenue recognition model and its consistency with the business model and underlying economics
- What processes are in place to ensure appropriate cut-off at year-end?
- Substantive reasons for fluctuations in financial performance
- How do the company’s policies and/or judgments compare to those of similar companies? How do they differ?
- Customary business practice used by Amazing in entering into arrangements with customers

June 2013:

“Amazing Inc is contemplating an exit”
The Unprepared Exit.....A Surprise IOI!!!

- **First:** Review the names on the Cap Table for grumps!
- How will you justify accepting a single bid?
- Will you engage an Investment Banker to attract other bids?
- Will you just buy a Fairness Opinion?
- What’s the venture’s BATNA? (Best Alternative to a Negotiated Agreement?)
- What’s the Board’s best defense? (Answer = **PROCESS**)!

Preparing for the Exit

- Will the CEO or a Director lead the Investment Banker selection process?
- Have you met with Bankers over the last year?
- Will you use an Investment Banker Questionnaire?
- Show the BOD samples of usual engagement letters (the “tail”)
- Educate the BOD regarding common issues mentioned in:
  - IOI (Indication of Interest Letter)
  - LOI (Letter of Intent)
Sale of the Company – Board Issues
• Understand well in advance
  – liquidation preferences, preferred participation waterfall at different values
  – employee option acceleration and severance packages
  – consider how the points above may influence management behavior – i.e., do you need a carve-out plan?
  – If buyers are serial, get their typical terms from your counsel
• Discuss with management the diligence process – who says what and when – need to manage understanding and overselling
• Keep an open but skeptical mind regarding investment banks
• Formally or informally, subset of investor board members should be working closely with management throughout process
• Assume most of the warts will come out, integrity and relationship with the principals of the buyer is the most important way to make a deal signs and closes

Terms of the Deal and Diligence
• Consider benefits of putting more detailed “legal” terms in non-binding LOI
• Indemnification terms – percentage escrow, survival, excluded representations, liability for fraud – have huge variability deal to deal
• Factors that influence legal terms – sophistication of counsel on both sides, buyer attitude towards risk, employee perception
• Consider separate investor counsel for indemnification and similar issues, company counsel is not protecting you
• D&O tail periods, strong continuing indemnification periods should be non-negotiable
• IP issues – consultant / university or other third-party ownership, open source, continue to be key diligence issues, as does 409A compliance
• Push to front-end employment offers and buyer employee
• 280g “golden parachute” excise taxes – can be triggered at low levels, but stockholder vote can cure
Impact of Exits

• Significant acquisition to the acquirer
• Due diligence call with auditor
• Impact to valuation of common stock

More Information / Resources

• PwC – Audit Committee Self Assessment
• PwC – Audit Committee Effectiveness; What Works Best ($85)
• PwC - Roadmap for an IPO; a guide for going public
• Cooley – Emerging Company Tips
• Cooley – Why CEOs Succeed and Why They Fail
• Cooley – Investment Policy (template)
• Ohio TechAngels – VC Questionnaire
• Ohio TechAngels – Investment Banker Questionnaire
Angel Resource Institute (ARI):

- Charitable organization and leading provider of education, information and research about angel investing.
- Founded by the Ewing Marion Kauffman Foundation
- Halo Report
- Education seminars and workshops -
  - Angel Investing Overview
  - Starting an Angel Organization
  - Due Diligence
  - Term Sheets
  - Trends in Raising Capital
  - Valuation of Early Stage Companies
  - Early Exits

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Q/A

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