

# Capitalization of the Venture: Founding & Funding

BIO Entrepreneurship Boot Camp  
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# Why Lawyers Like Start-Ups



**regulatory filings (federal and state)**

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**licensing agreements**

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**stock purchase documents; stockholders agreements**

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**employment/consulting agreements;  
stock option plans**

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**articles of incorporation; by-laws**

# Why all the Docs

**Memory** What did we agree to?

**Governance** Who gets to decide what

**Exit** Who gets what (and in what order)

**Disputes** See “Memory” above

In the Beginning . . .

# Formation

why?

In the Beginning . . .



**Value Proposition  
for Investors**

# The Value Proposition

how good is the story

Entity structure, equity distribution, employee compensation are understandable, appropriate and consistent with typical arrangements

Risks associated with technology development and product acceptance have been identified, and strategies for minimizing them are sensible

Estimates of market size, timeline to market entry; pace of acceptance (and scale of reimbursement) are credible

# The Value Proposition

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Entity structure, equity distribution, financing terms, employee compensation are understandable, appropriate and consistent with typical arrangements

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Estimates of market size, timeline to market entry; pace of acceptance (and scale of reimbursement) are credible

# The Value Proposition – what matters

**Novel**

**Not  
Novel**





In the Beginning . . .

**Formation**

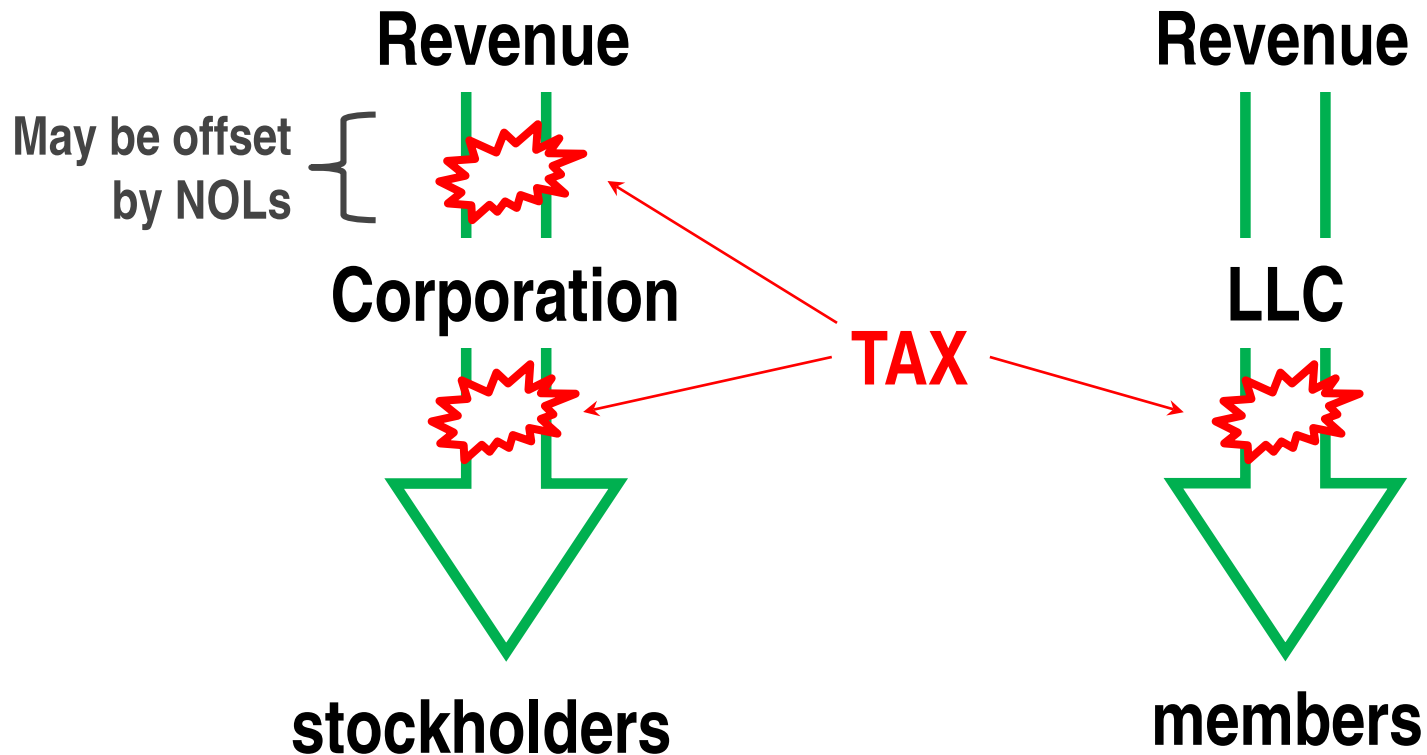
**what?**

# Types of Entities

<b>Corporation</b>	<b>the default choice; well-understood capital &amp; operational structure</b>
<b>Limited Liability Company (LLC)</b>	<b>tax advantages; simplified operational structure (ex. members as employees)</b>

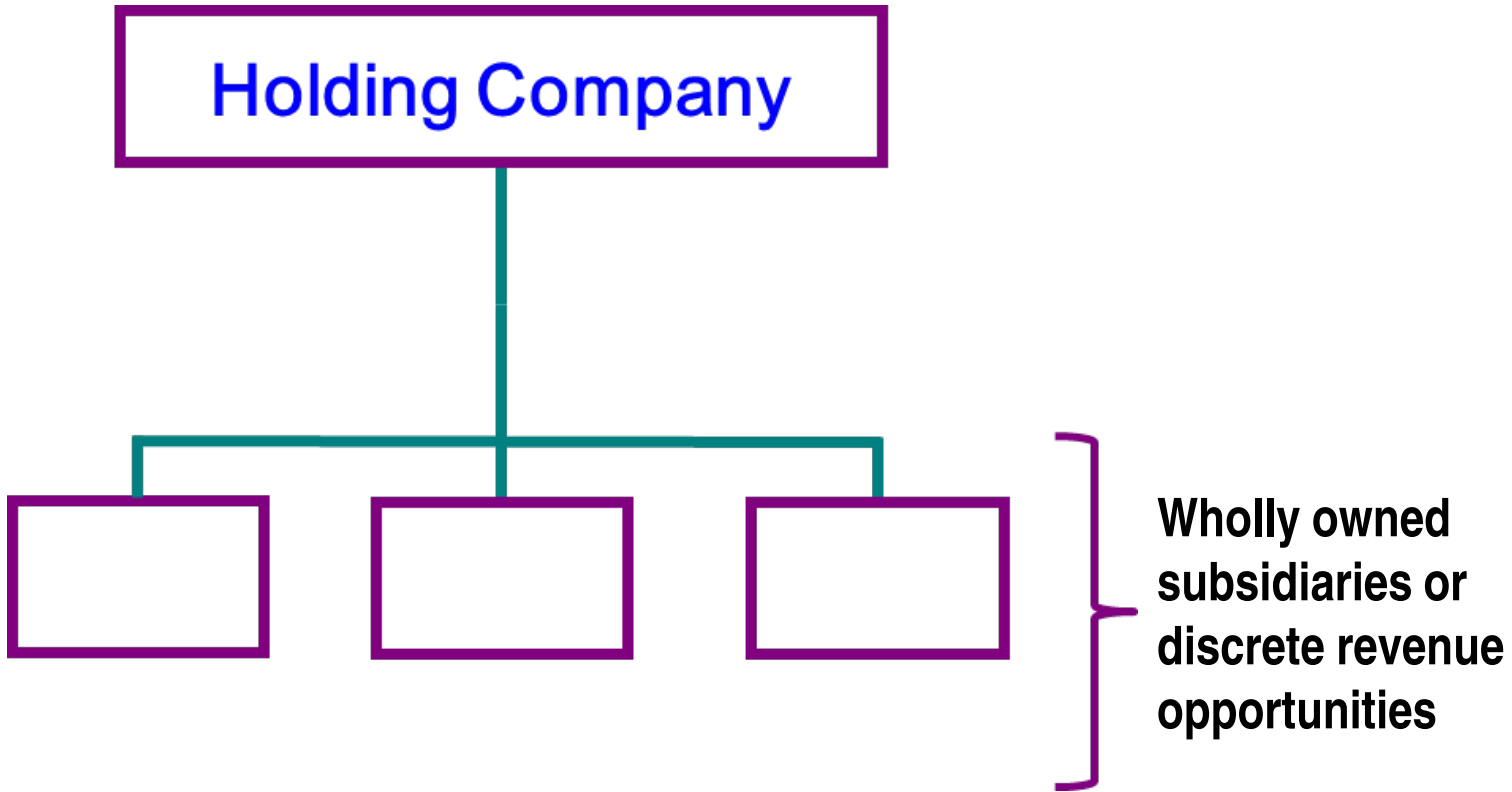
**Also, where to incorporate/organize?**

# Taxation Models



but, cap. gains tax “forgiveness” for “C” corp. stock sale (IRC§1202)

# LLC Model for Discrete IP/Product Assets



**also, consider IRS perspective on employees as members**

# Governance (and the Board – CEO relationship)



**Influenced by: timely communication (esp. bad news; adherence to Board policies)**

# The Early Life of the Company

<b>Stage</b>	<b>Goals</b>
<b>Launch</b>	<i>establish governing structure; allocate ownership interests (establish control over IP)</i>
<b>Financing</b>	<i>Money (could also establish key relationships in financing &amp; tech. development)</i>
<b>R&amp;D (&amp;C)</b>	<i>enable/accelerate technology development, market entry</i>

# Financing (Documentation)

<b>Document</b>	<b>Purpose</b>
Term Sheet	<i>Preliminary terms of investment: pre-investment valuation; class &amp; rights of stock to be sold; issue price; board representation; closing conditions (due diligence; aggregate investment commitment)</i>
Purchase Agreement, etc.	<i>Definitive investment terms; ancillary agreements; company reps &amp; warranties; pre- &amp; post-closing conditions</i>

# Financing (Documentation – equity round)

Document	Purpose
Stockholders Agreement	<b>Rights/Obligations applicable to all Stockholders</b> <i>(i.e., restrictions on transfer of shares; designation of board nominees &amp; election of directors, etc.)</i>
Investor Rights Agreement	<b>Rights/Obligations applicable to Investors</b> <i>(i.e., preemptive purchase rights, protective provisions, registration rights, etc.)</i>
<i>Right of First Refusal &amp; Co-Sale Agreement</i>	<i>allow Company and then stockholders to purchase selling stockholders' shares; require stockholders to sell shares along with selling stockholders</i>
<i>Voting Agreement</i>	<i>require stockholders to vote on certain matters (esp. election of directors, but can require votes on other matters)</i>



# Financing (Key Investment Terms – Preferred Stock)

<b>Term</b>	<b>Function</b>	<b>Purpose</b>
<b>Liquidation Preference</b>	<b>Return of initial investment (+ dividends) ahead of general distribution to stockholders</b>	<b>Downside protection (if just 1X) Upside benefit (if &gt; 1X)</b>
<b>Anti-Dilution</b>	<b>Downward adjustment of initial issue price if future round priced lower</b>	<b>Downside protection against over-valuation of the company for the initial investment</b>
<b>Voting Rights</b>	<b>Board representation Protective provisions</b>	<b>Ability to influence (maybe control) future key decisions about the business &amp; exit</b>

# Financing (Key Securities Laws)



**Keep it simple**  
**Keep it accurate**

## The Rules:

SEC (“1933 Act”) – exemption from registration

State “Blue Sky” requirements – prior registration?

“Accredited” Investors

Investor Disclosures – material facts; no material omissions

private-private vs. public-private offerings (Rule 506(b) vs. 506(c)\*)

\*(e.g., [www.verifyinvestor.com](http://www.verifyinvestor.com))

# Financing (what matters)

<b>What</b>	<b>Why</b>
<b>Valuation</b>	<i>Establishes relative equity interest acquired by new investors (may trigger anti-dilution rights of older investors – a “down round”))</i>
<b>Capitalization</b>	<i>Establishes relative voting rights and liquidation preferences of all stockholders</i>

# Financing (Valuation)

<b>“Pre-Money”</b>	<b>\$6,000,000</b>	<b>60%</b>	<b>Represents value attributed to all shares sold or reserved (i.e., options) pre-financing</b>
<b>Investment</b>	<b>\$1,000,000</b>	<b>10%</b>	<b>Principal + interest of conv. notes</b>
	<b>\$3,000,000</b>	<b>30%</b>	<b>New money</b>
<b>“Post-Money”</b>	<b>\$10,000,000</b>	<b>100%</b>	<b>Represents value attributed to all shares sold or reserved (i.e., options) post-financing, at financing issue price</b>

How determined – negotiation; benchmarking

# Financing (Therapeutic Valuation Metrics)\*

## Seed Round - in millions

Pre-Money	Capital Raise	Post-Money
6.5 +/- 2.3	0.9 +/- 0.8	7.4 +/- 3.1

|----- ~15 months -----|

- Proof of concept with IND candidates
- Selection of clinically relevant animal model(s)

## 1st Round - in millions

Pre-Money	Capital Raise	Post-Money
9.6 +/- 7	6.9 +/- 7.7	16.5 +/- 14.7

|----- ~19 months -----|

- Rodent and non-rodent tox data
- Selection of IND enabling compound

## 2nd Round - in millions

Pre-Money	Capital Raise	Post-Money
35.7	13.2 +/- 13.9	48.9 +/- 13.9

|----- ~17 months -----|

- Human safety (Phase I)

## 3rd Round - in millions

Pre-Money	Capital Raise	Post-Money
50.0	17.3 +/- 17	67.3 +/- 17

|----- ~13 months -----|

- Efficacy studies in patients
- Patient dose range studies (Phase IIb)

## 4th Round - in millions

Pre-Money	Capital Raise	Post-Money
148.3	29.8	178.1

- Phase III

## Exit Details

Capital Raise	Exit Value	Months
~70	~226.7	~60-84 months

\*data compiled by and made available through Pittsburgh Life Sciences Greenhouse

# Financing (Therapeutic Valuation Metrics)

Seed Round - in millions			1st Round - in millions		
Pre-Money	Capital Raise	Post-Money	Pre-Money	Capital Raise	Post-Money
6.5 +/- 2.3	0.9 +/- 0.8	7.4 +/- 3.1	9.6 +/- 7	6.9 +/- 7.7	16.5 +/- 14.7
----- ~15 months -----			----- ~19 months -----		
<ul style="list-style-type: none"> <li>• Proof of concept with IND candidates</li> <li>• Selection of clinically relevant animal model(s)</li> </ul>			<ul style="list-style-type: none"> <li>• Rodent and non-rodent tox data</li> <li>• Selection of IND enabling compound</li> </ul>		

Exit Details		
Capital Raise	Exit Value	Months
~70	~226.7	~60-84 months

# Certificate of Incorporation – Stock Classes

Authorized Shares

## ARTICLE VI

### A. CLASSES OF STOCK; RANK.

1. Designation of Series. The aggregate number of shares of stock that the Corporation shall have the authority to issue shall be 63,000,000 shares, consisting of (a) 35,000,000 shares of Common Stock, \$0.001 par value per share (“Common Stock”), and (b) 28,000,000 shares of Preferred Stock, par value \$0.001 per share. 13,000,000 shares of which shall be designated Series A Convertible Participating Preferred Stock (the “Series A Preferred Stock”), 5,000,000 shares of which shall be designated Series B Convertible Participating Preferred Stock (the “Series B Preferred Stock”) and 10,000,000 shares of which shall be designated Series C Convertible Participating Preferred Stock (the “Series C Preferred Stock”). The original issuance price of the Series A Preferred Stock shall be \$1.04 per share (the “Original Series A Issue Price”), the original issuance price of the Series B Preferred Stock shall be \$1.126 per share (the “Original Series B Issue Price”), and the original issuance price of the Series C Preferred Stock shall be \$1.5055 per share (the “Original Series C Issue Price”). The Series A Preferred Stock, the Series B Preferred Stock and the Series C Preferred Stock are referred to collectively as the “Preferred Stock”.

# Certificate of Incorporation – Liquidation

## 2. Liquidation.

(a) Series C Liquidation Amount. In the event of any liquidation, dissolution or winding up of the Corporation (each such event, a “Liquidation Event”), either voluntary or involuntary, the holders of Series C Preferred Stock shall be entitled to receive, prior and in preference to any distribution of any of the assets of the Corporation to the holders of Junior Shares, by reason of their ownership thereof, an amount per share equal to the sum of (i) One Hundred Percent (100%) of the Original Series C Issue Price (as adjusted for any stock splits, stock dividends, reverse stock splits, stock combinations and other similar capitalization changes) (such sum, the “Series C Liquidation Amount”). If upon the occurrence of a Liquidation Event, the assets and funds legally available for distribution to stockholders shall be insufficient to permit the payment to all holders of Series C Preferred Stock of the full Series C Liquidation Amount, then the entire assets and funds of the Corporation legally available for distribution to stockholders shall be distributed ratably among the holders of Series C Preferred Stock based on the preferential amounts each such holder is otherwise entitled to receive.

**“Liquidation Event”  
Includes M&A exits**

**Liquidation  
Preference Amount**

**Seniority in  
Liquidation**



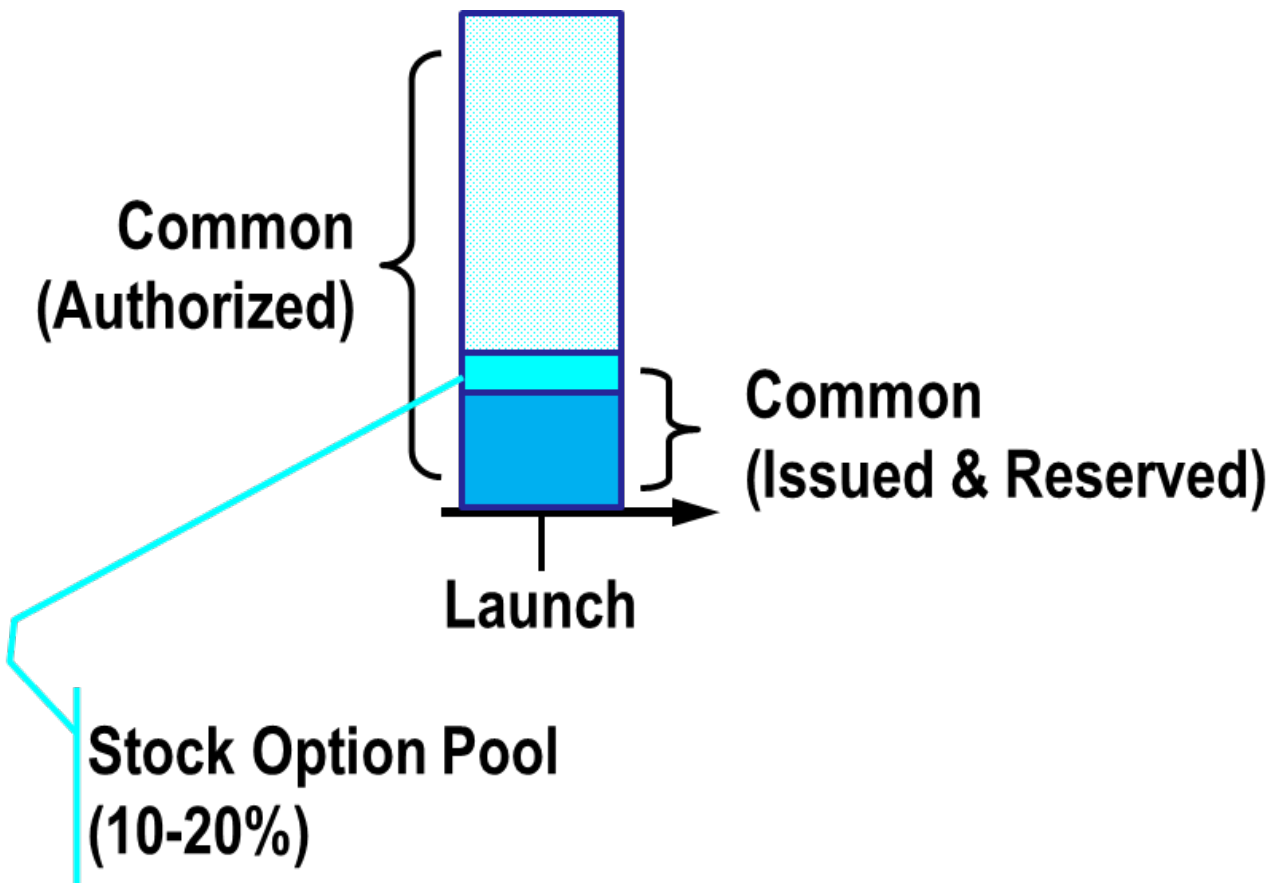
# The “Participation” Reward



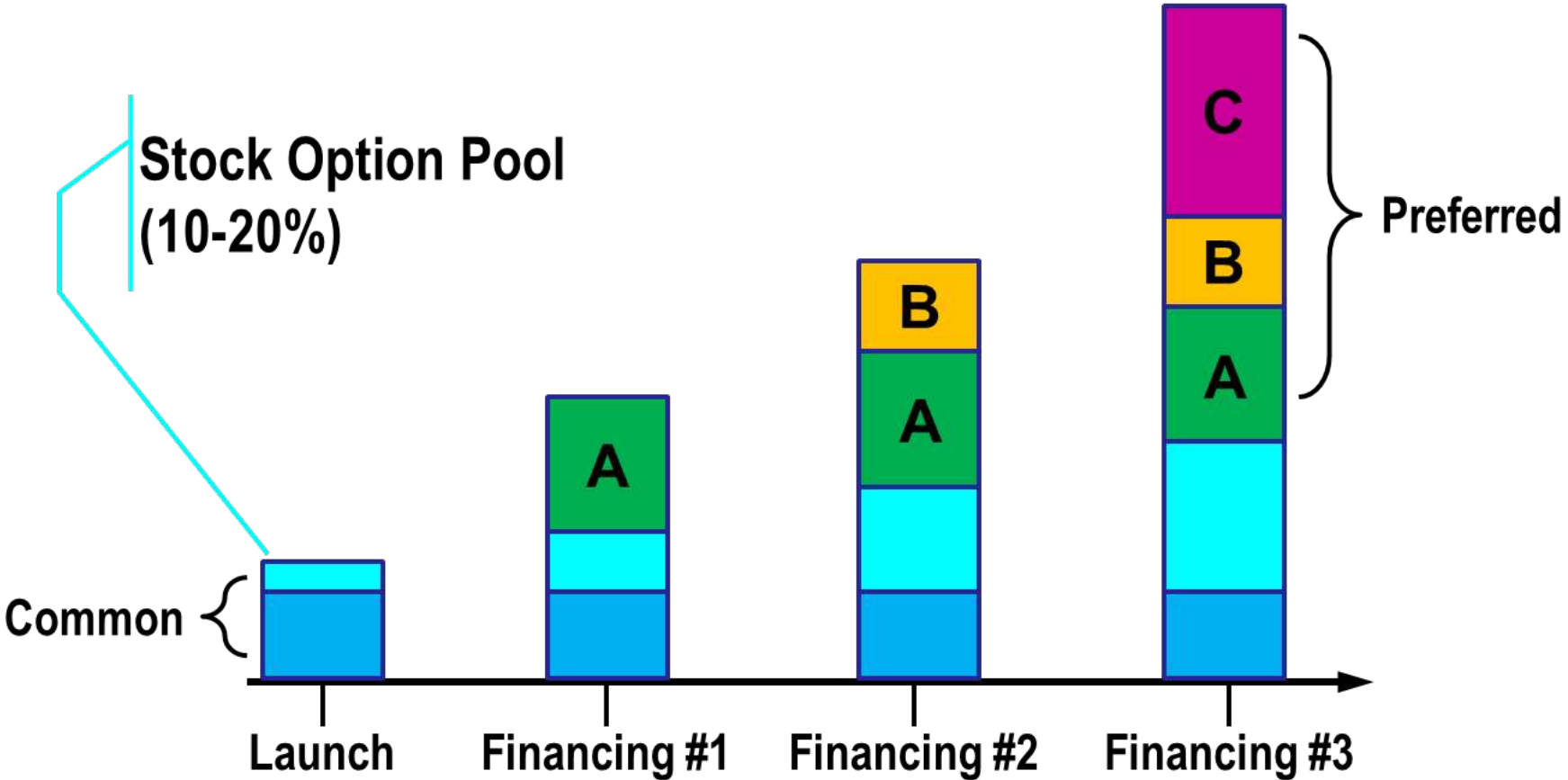
**“Participating” Preferred Stock Payout = Liquidation Preference Amount + pro rata portion (calculated with common stock on conversion of all preferred stock to common) of Exit proceeds remaining after all junior Preferences paid**

**Participation “Cap” – preferred holder entitled to either (i) the cap amount (i.e., 2X liq. pref.), or (ii) the amount payable if the preferred stock was non-participating (i.e., participates in the total proceeds with common stock on an as-converted to common stock basis**

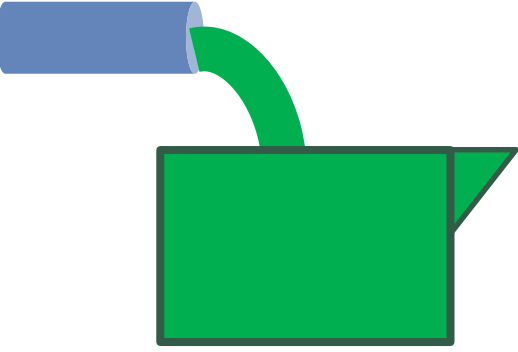
# Financing (Capitalization)



# Financing (future rounds)



# Financing -- Liquidation “Waterfall”



-- Series C “Liquidation Preference”



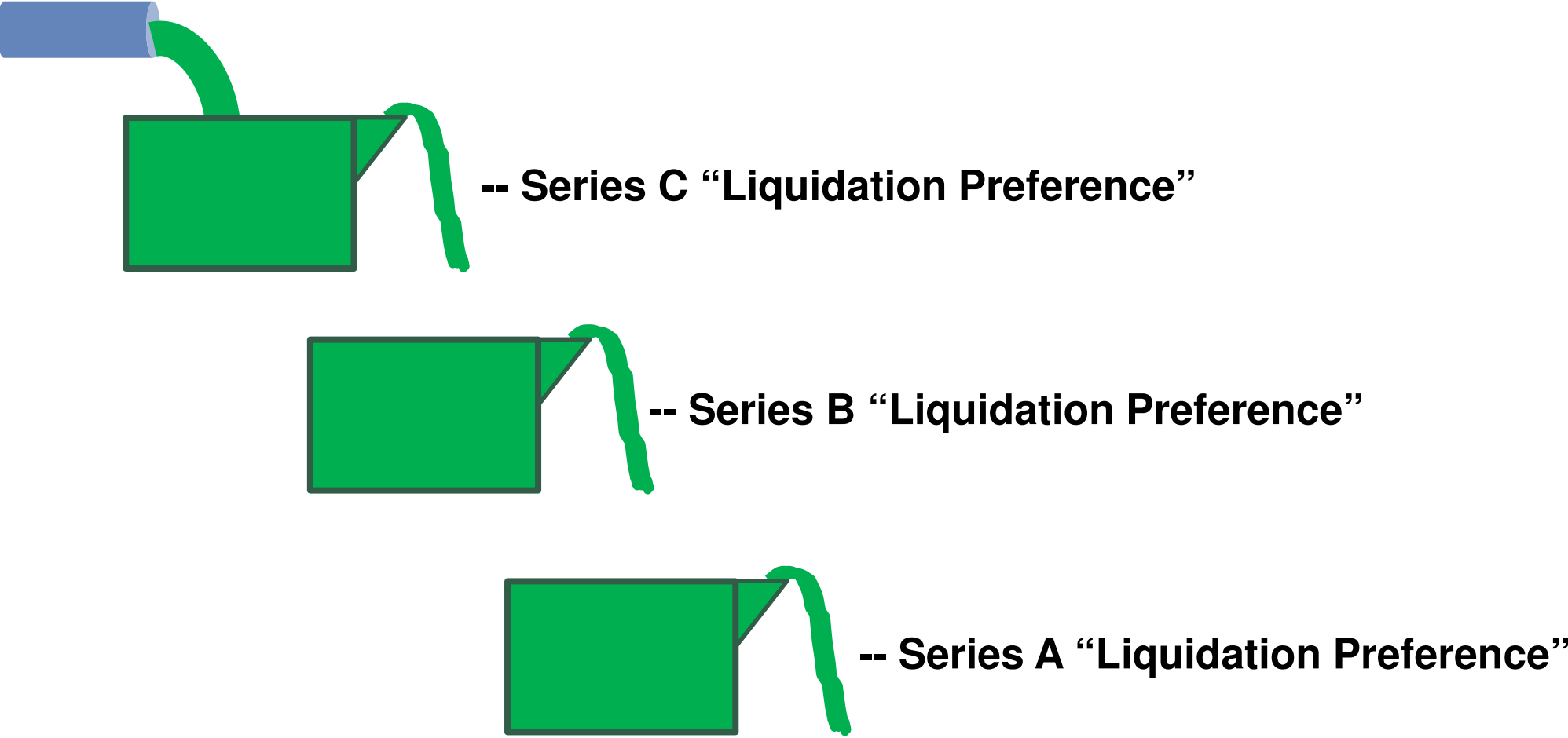
-- Series B “Liquidation Preference”



-- Series A “Liquidation Preference”

Common + “Participating” Preferred

# Financing -- Liquidation “Waterfall”



Common + “Participating” Preferred

# Liquidation Waterfall -- \$60M Exit, Participating Preferred

<b>Exit Proceeds</b>	<b>\$60,000,000</b>	<b>Amount remaining after payment of outstanding debt, etc.</b>
<b>Liquidation Preference Payouts</b>	<b>-\$10,000,000</b>	<b>Series C</b>
	<b>-\$5,000,000</b>	<b>Series B</b>
	<b>-\$5,000,000</b>	<b>Series A</b>
<b>Net Exit Proceeds</b>	<b>\$40,000,000</b>	<b>Amount to be distributed to Common + Participating Preferred on pro rata basis</b>

# Liquidation Waterfall -- \$60M Exit, Participating Preferred

	<b>% of Issued Shares (as converted to Common)</b>	<b>Liquidation Preference</b>	<b>Distribution of Net Exit Proceeds</b>	<b>Total Distribution (~% of Exit)</b>
<b>Series C</b>	<b>45%</b>	<b>\$10,000,000</b>	<b>\$18,000,000</b>	<b>\$28,000,000 (46.7%)</b>
<b>Series B</b>	<b>25%</b>	<b>\$5,000,000</b>	<b>\$10,000,000</b>	<b>\$15,000,000 (25%)</b>
<b>Series A</b>	<b>20%</b>	<b>\$5,000,000</b>	<b>\$8,000,000</b>	<b>\$13,000,000 (21.7%)</b>
<b>Common</b>	<b>10%</b>	<b>N/A</b>	<b>\$4,000,000</b>	<b>\$4,000,000 (6.7%)</b>

# Participation Cap “Indifference” – Series C Distribution

	<b>% of Issued Shares (as converted to Common)</b>	<b>Total Distribution</b>	<b>Liquidation Preference</b>	<b>2X Cap Distribution</b>
<b>\$60M Exit</b>	<b>45%</b>	<b>\$27,000,000</b>	<b>\$10,000,000</b>	<b>\$20,000,000</b>
<b>\$40M Exit</b>		<b>\$18,000,000</b>		<b>\$20,000,000</b>

**Participation Cap can leave more for Common Holders at higher Exit and leave less for Common Holders at lower Exit; also, disincentive for Preferred Holders with Cap to seek higher Exit until Exit return greater than Cap payout**





**Pepper Hamilton LLP**  
Attorneys at Law

# Capabilities

## Best Lawyers

More than 60 lawyers listed, including 5 as Lawyer of the Year

## 100+

lawyers highly rated by Super Lawyers and Rising Stars

## SERVICES

BUSINESS SERVICES  
INTELLECTUAL PROPERTY  
GOVERNMENT REGULATION  
INTERNATIONAL LITIGATION

## INDUSTRIES

CONSTRUCTION LAW  
EDUCATION COUNSELING, LITIGATION AND INVESTIGATION SERVICES  
ENERGY INDUSTRY GROUP  
FINANCIAL SERVICES  
FOOD AND BEVERAGE INDUSTRY  
HEALTH CARE SERVICES  
INVESTMENT FUNDS INDUSTRY GROUP  
LIFE SCIENCES  
MEDIA, COMMUNICATIONS AND ENTERTAINMENT  
NONPROFIT ORGANIZATIONS AND FOUNDATIONS  
PHARMACEUTICALS AND MEDICAL DEVICES  
RETAIL INDUSTRY  
TRANSPORTATION

# Health Sciences

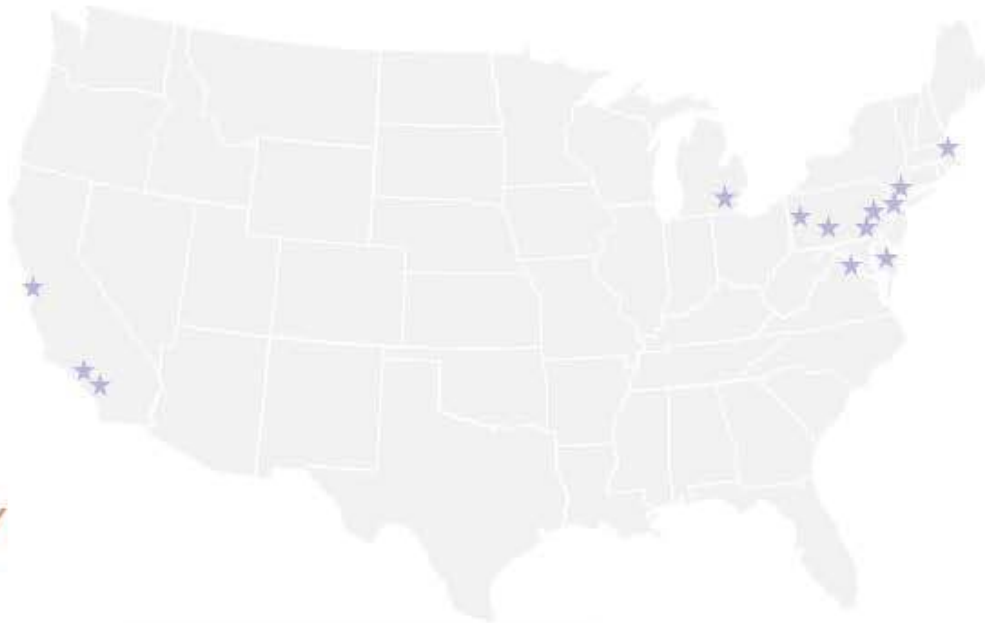
- ▶ more than 100 lawyers devoted to advising clients across the health sciences spectrum
- ▶ collaborate with each other and with clients to achieve remarkable successes
- ▶ understand the impact that advice and counsel in one area will have in other aspects of business – and on other members of the health sciences ecosystem

## Key areas of practice

Acute Care Hospitals and Health Systems  
Antitrust and Competition - Health Sciences  
Digital Health  
FDA Regulatory and Risk Management  
Counseling  
Fraud and Abuse Litigation and Investigations  
Group Purchasing Organizations and Buying  
Cooperatives  
Health Care Services  
Health Care Transactions  
Intellectual Property - Health Sciences  
Life Sciences Transactions  
Long-Term Care Organizations – Skilled  
Nursing and Senior Housing Facilities  
Pharmaceutical and Medical Device Litigation  
and Counseling  
Pharmacy Industry  
State Attorney General Litigation  
White Collar Litigation and Investigations

# Locations

BERWYN  
BOSTON  
DETROIT  
HARRISBURG  
LOS ANGELES  
NEW YORK  
ORANGE COUNTY  
PHILADELPHIA  
PITTSBURGH  
PRINCETON  
SILICON VALLEY  
WASHINGTON  
WILMINGTON



**Legal 500**

Recommended firm for  
Construction Litigation  
and Pharma/Medical  
Device Products  
Liability

**500+** lawyers

**13** offices in U.S.

**125** years of  
serving clients

# The Early Life of the Company

Stage	Documents
<b>Launch</b>	<i>Corp:</i> Articles/Certificate of Incorporation; Bylaws <i>LLC:</i> Operating Agreement <i>(Restricted Stock/Unit Agreement)</i> <i>(IP License Agreement)</i>
<b>Financing</b>	Term Sheet; Purchase Agreement <i>Corp:</i> Stockholders Agmt; Inv. Rights Agmt; (etc.) <i>LLC:</i> Amended & Restated Oper. Agmt
<b>R&amp;D (&amp;C)</b>	Development/License Agreement; JV Agreement

# The Early Life of the Company - Launch

<b>Document</b>	<b>Purpose</b>
Articles/Certificate of Incorporation	<i>authorized capitalization; rights and preferences of each authorized stock class (esp. dividend, liquidation, anti-dilution); extraordinary voting rights of stock classes;</i>
Bylaws	<i>meetings &amp; voting of stockholders and directors; offices and duties of officers</i>
Operating Agreement	<i>All of the above</i>
<i>IP License Agreement</i>	<i>establish authority to control use of IP</i>
<i>Restricted Stock/Unit Agreement</i>	<i>correlate future participation with equity interest</i>