



**Biotechnology**  
Innovation Organization

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#BIO2023  
#StandUpForScience

# Biotechnology Entrepreneurship Boot Camp

Presented by:

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*BIO Recognizes Course Sponsor:*



**McDonnell Boehnen  
Hulbert & Berghoff LLP**  
Intellectual Property Law

# **The Mechanics of Capitalizing Your Venture**

**Formation, Governance, Financing & the “Waterfall”**

**BIO Entrepreneurship Boot Camp 2023**  
**Session 19**

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In the Beginning . . .

**Formation**

**why?**

# 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



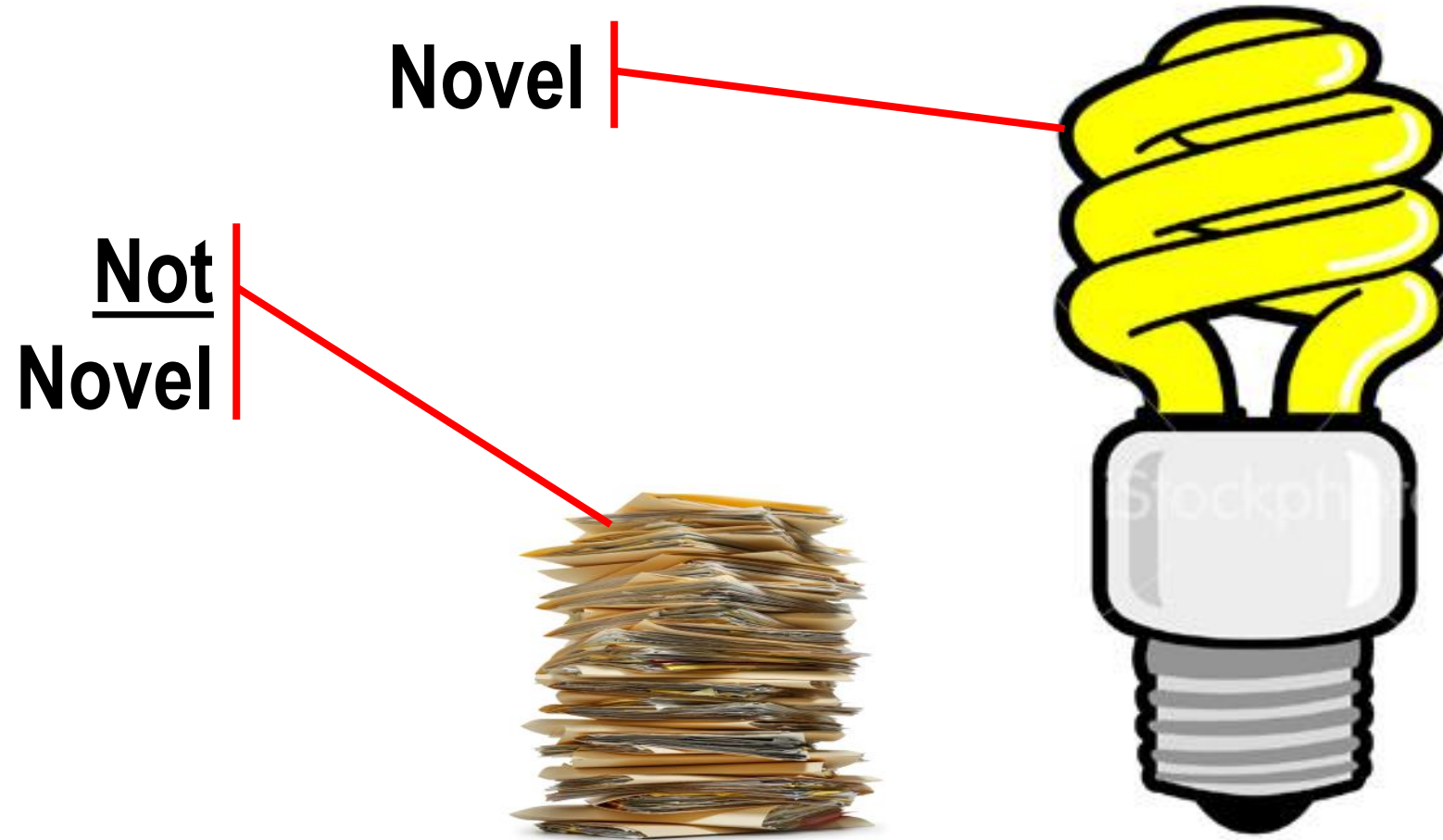
how good is the story

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# The Value Proposition – what matters



In the Beginning . . .

**Formation**

why?  
**what?**

# Types of Entities

**“C” Corporation** the default choice; well-understood capital & operational structure; M&A/IPO advantages

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**Limited Liability Company (LLC)** tax advantages (esp. for partial exits); simplified operational structure (ex. members as employees)

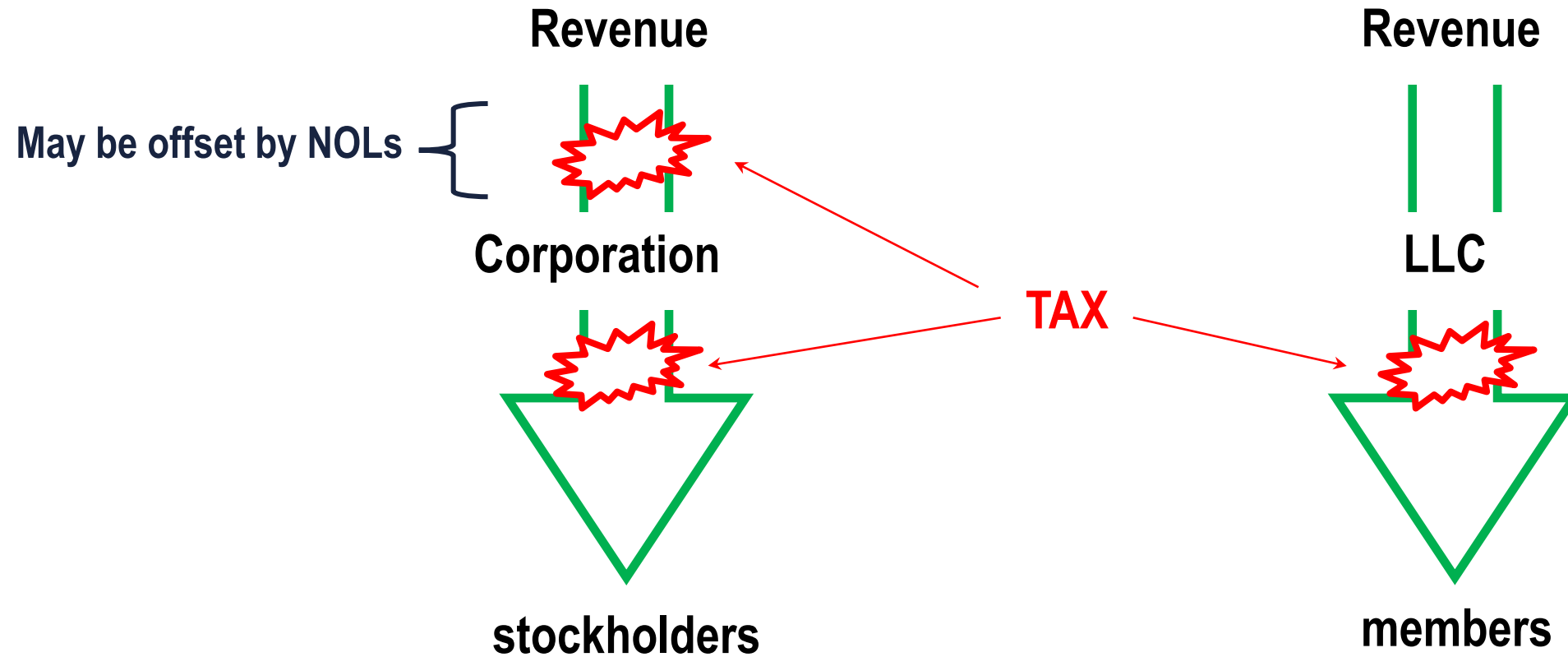
**Also, where to incorporate/organize?**



# Words Meaning (Essentially) the Same Things

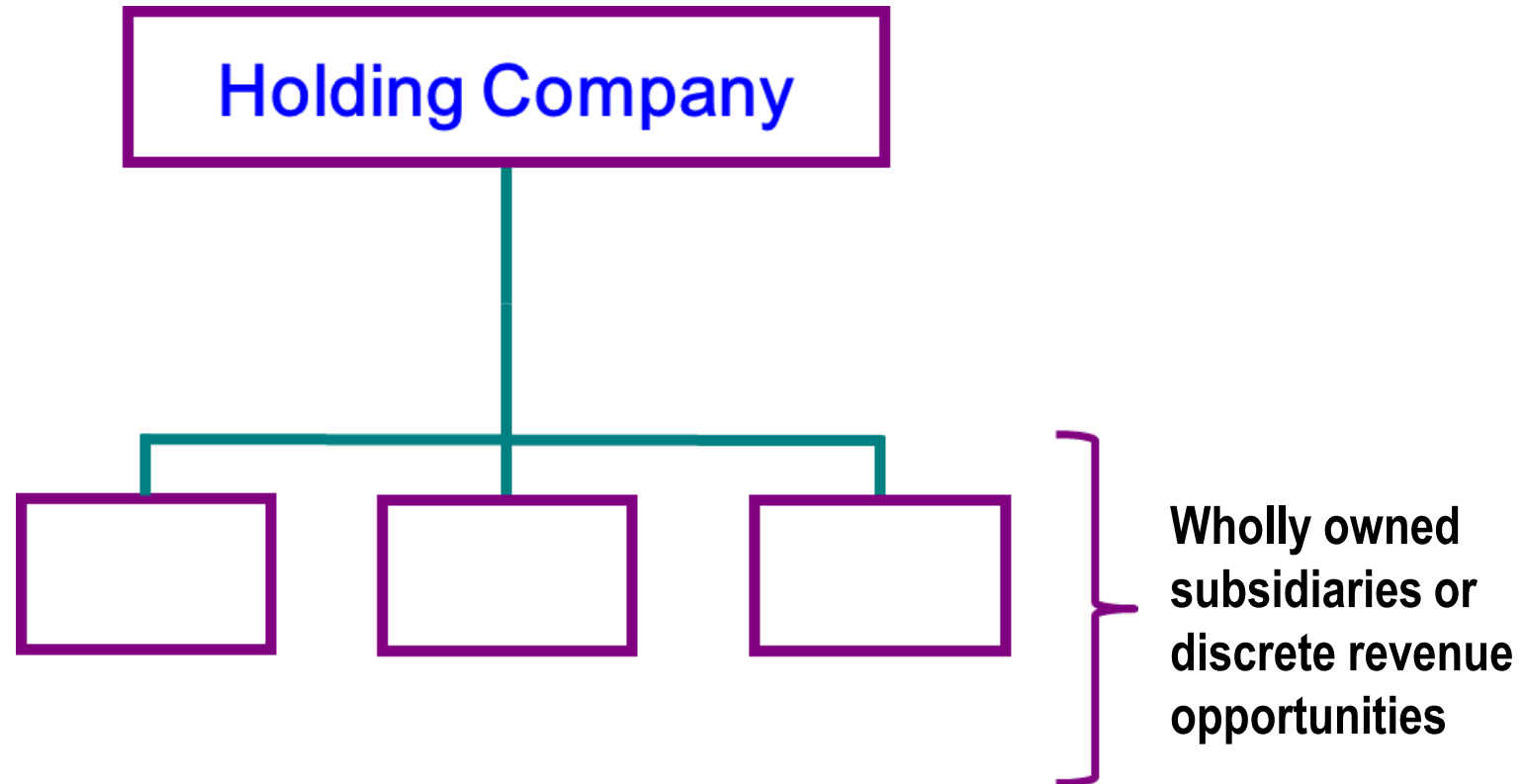
<b>Corporation</b>	<b>LLC</b>
<b>Board of Directors</b>	<b>Board of Managers</b>
<b>Stockholders</b>	<b>Members</b>
<b>Capital stock</b>	<b>Membership interests (“Units”)</b>
<b>Stock options</b>	<b>Profits interest</b>

# 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**

# Angel Capital Association – 2021 Angel Funders Report

([www.angelcapitalassociation.org](http://www.angelcapitalassociation.org))

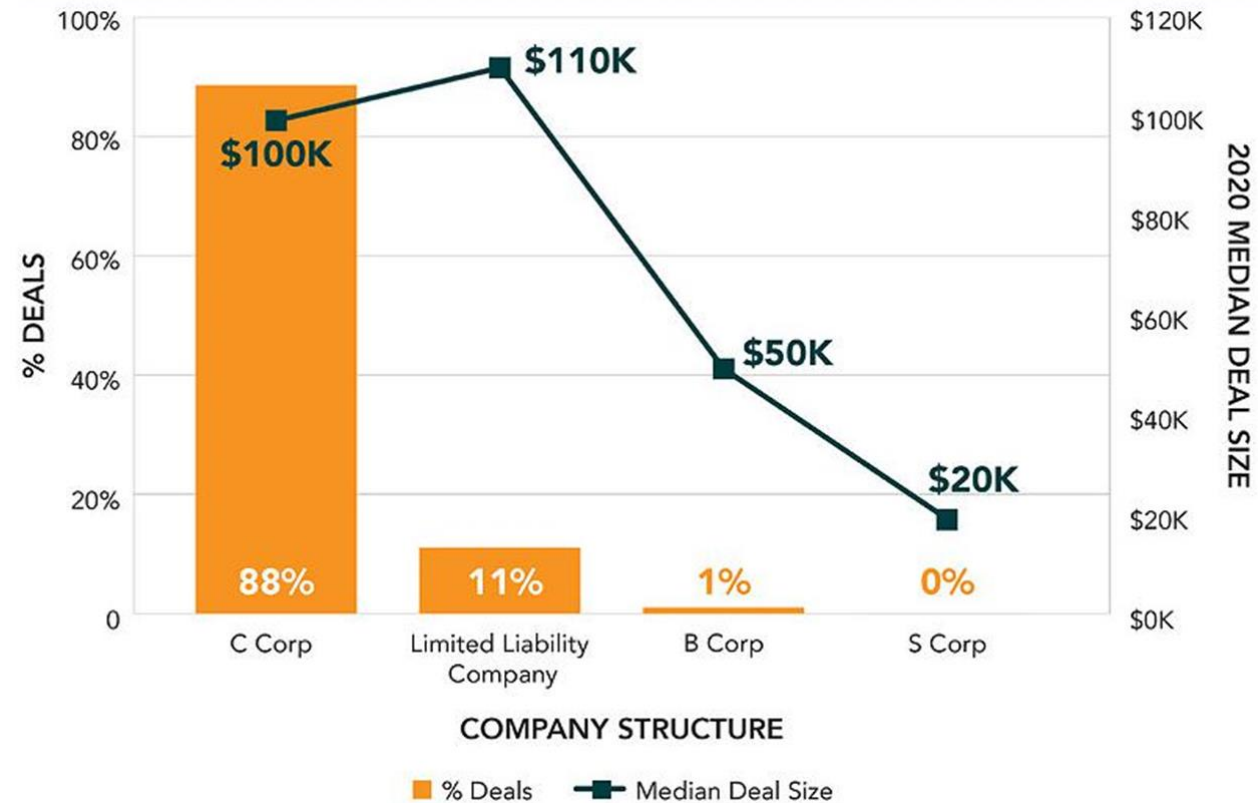


Figure 16 – C Corp Dominate Company Structures

In the Beginning . . .

**Governance**

# Governance 101

Entity Element	Role / Rights
<b>Board of Directors/Managers</b>	<b>Fiduciary duty to oversee Entity on behalf of shareholders/members</b> <b>Act through management team (esp. CEO)</b> <b>Comprised of: investors, CEO, outsiders, founders(?)</b>
<b>Stockholders/Members</b>	<b>Elect Directors/Managers</b> <b>Dependent on Board/Management to produce ROI</b> <b>Vote on fundamental changes (financing, exit)</b> <b>Not involved in day-day operations (ex. informally)</b>

# Governance (who decides what)\*

<b>Board</b>	<b>Stockholders</b>
<b>Budget</b> (reflecting tech. & bus. dev. priorities) <b>Mgmt. Compensation</b> <b>Material Agreements</b> <b>Exit Planning</b>	<b>Future financings</b> <b>Exit</b>  (other protective provisions?)

**\*see Bylaws, Stockholders Agreement, Investor Rights Agreement, Voting Agreement**

# Governance (and the Board – CEO relationship)



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



Becoming operational . . .

**Financing**

**process**

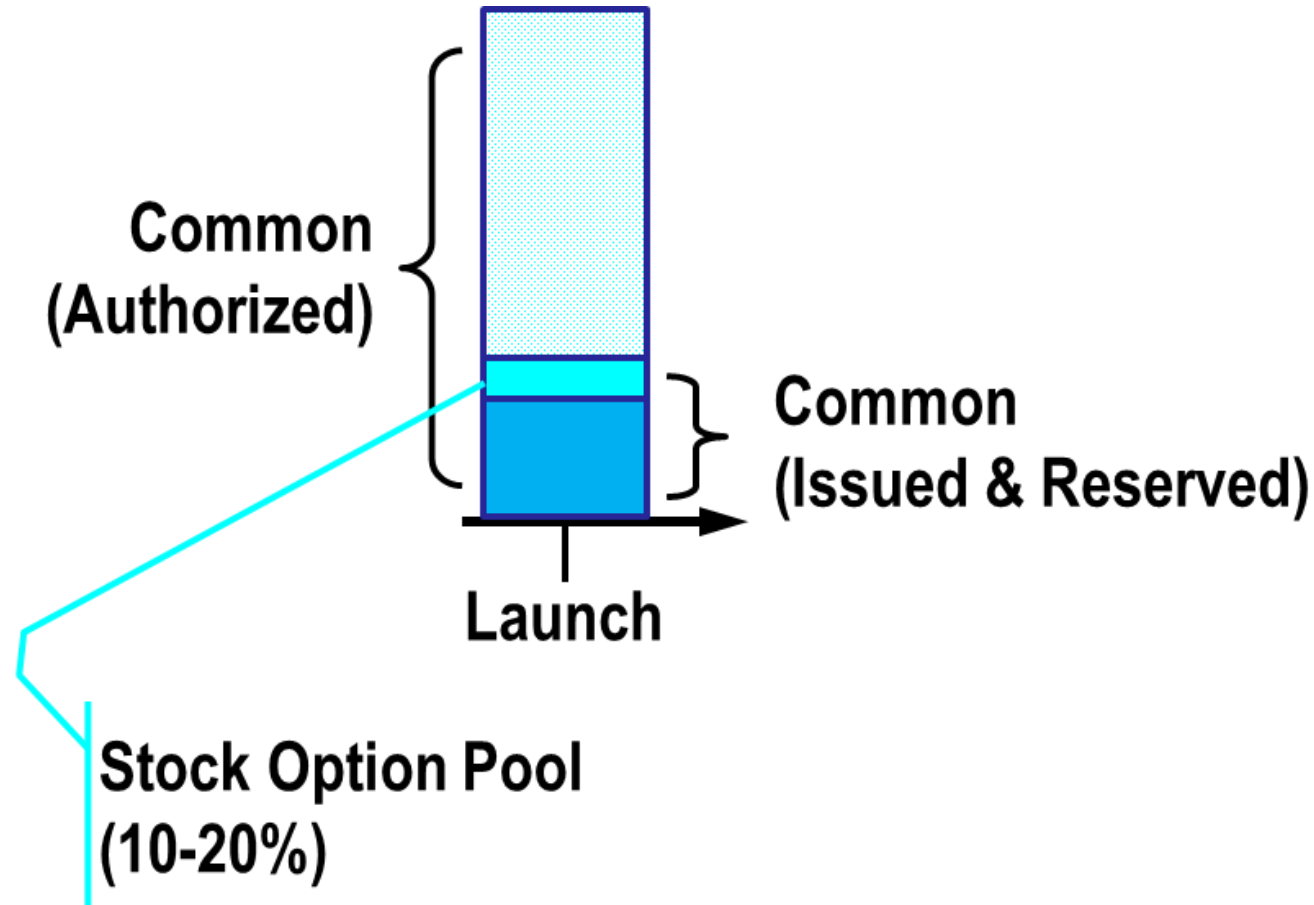
**key elements/terms**

# Capitalization

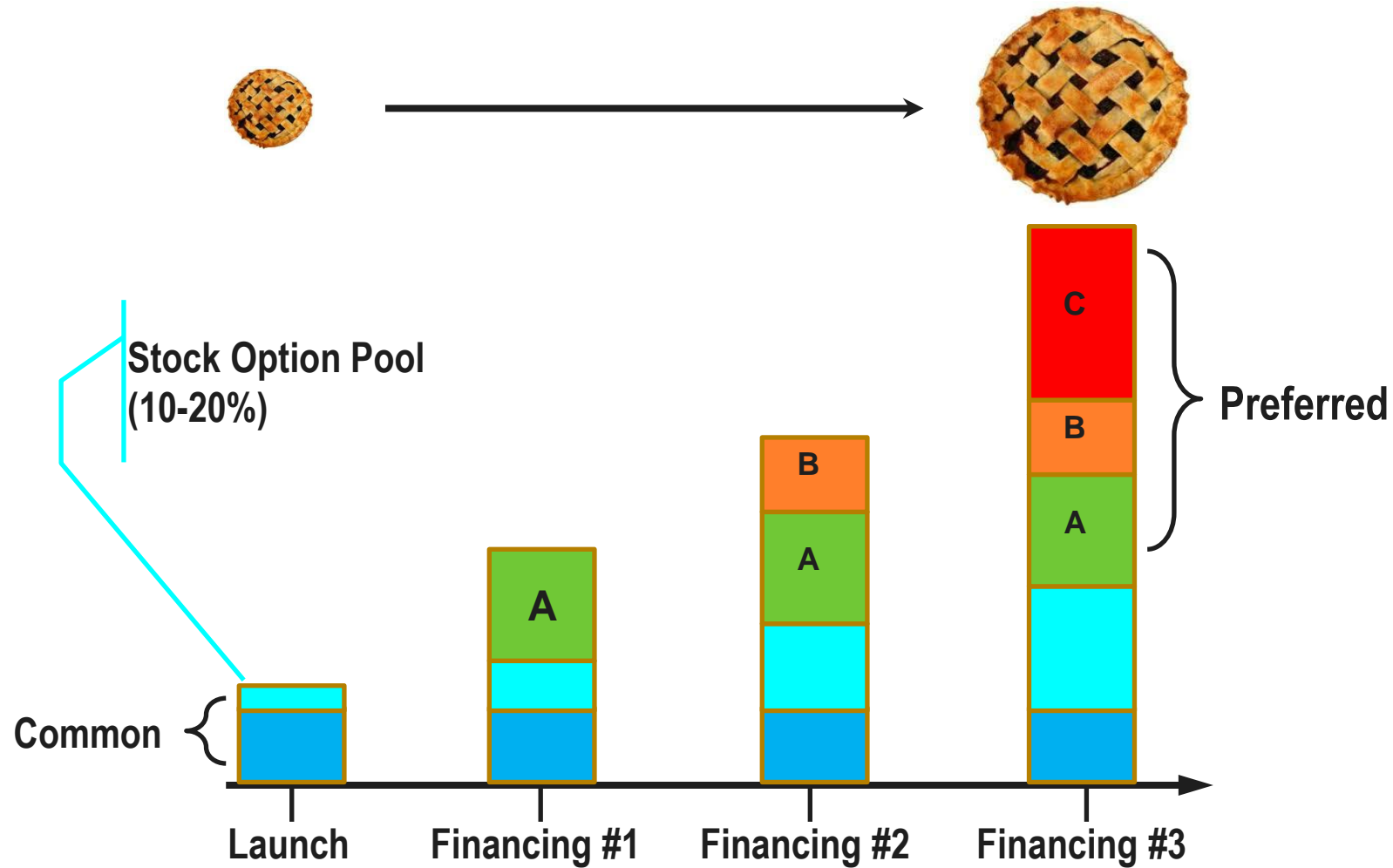
<b>Capital Stock</b>	<b>What's Included</b>
<b>Authorized</b>	<b>Everything</b> (max. number of shares of any kind the company can issue or reserve)
<b>Issued</b>	<b>Common</b> (initially – to founders) and <b>Preferred</b> (to investors)
<b>Reserved</b>	<b>Stock Option Pool, Warrants</b>

**“Fully Diluted”** – relative equity interest based on sum of all issued and reserved shares (all as converted to common)

# Financing (Capitalization)



# Financing (Building the Cap Table)



# Financing (Process & Documentation)



Document	Purpose
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 (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 (Key Securities Laws)

## The Rules:

**SEC (“1933 Act”) – exemption from registration**

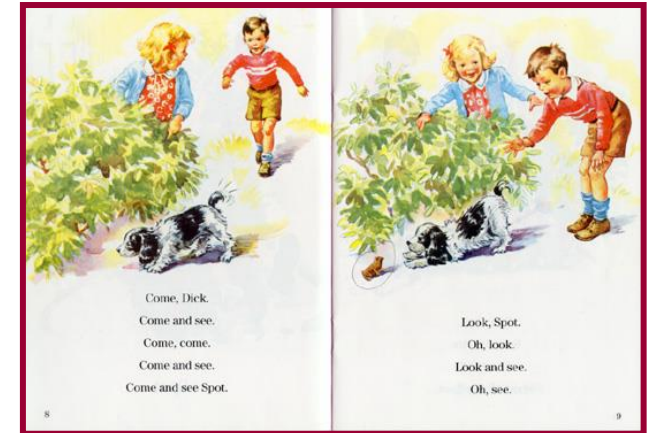
**but consider state “Blue Sky” requirements – prior registration?**

**Investor Disclosures – material facts; no material omissions**

**“Accredited” Investors – having ability to withstand loss and evaluate risk**

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

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



**Keep it simple  
Keep it accurate**

# The Early Life of the Company – Financing (Overview)

Structure	Valuation	Investor Rights	Founder Commitment	Documentation
<u>Debt</u> (conv. note)*	N/A	<ul style="list-style-type: none"> <li>▪ Information rights</li> <li>▪ Cap on add'l debt</li> <li>▪ Conversion terms</li> </ul>	<ul style="list-style-type: none"> <li>▪ Employment</li> <li>▪ Restrictive covenants</li> <li>▪ Equity vesting</li> </ul>	<ul style="list-style-type: none"> <li>▪ Purchase Agmt</li> <li>▪ Note</li> <li>▪ Warrant?</li> </ul>
<u>Equity</u> (“seed” or Series A)	Negotiated	<ul style="list-style-type: none"> <li>▪ Information rights</li> <li>▪ Board seat?</li> <li>▪ Future Purchase right</li> <li>▪ Voting rights</li> </ul>		<ul style="list-style-type: none"> <li>▪ Purchase Agmt</li> <li>▪ Stkhldrs Agmt</li> <li>▪ Invstr Rights Agmt</li> </ul>

\*beware tax issues for LLC members



# Financing (Documentation – equity round)

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

\*see NVCA model Series A transaction documents ([www.nvca.org](http://www.nvca.org))

# Financing (Key Investment Terms – Preferred Stock)

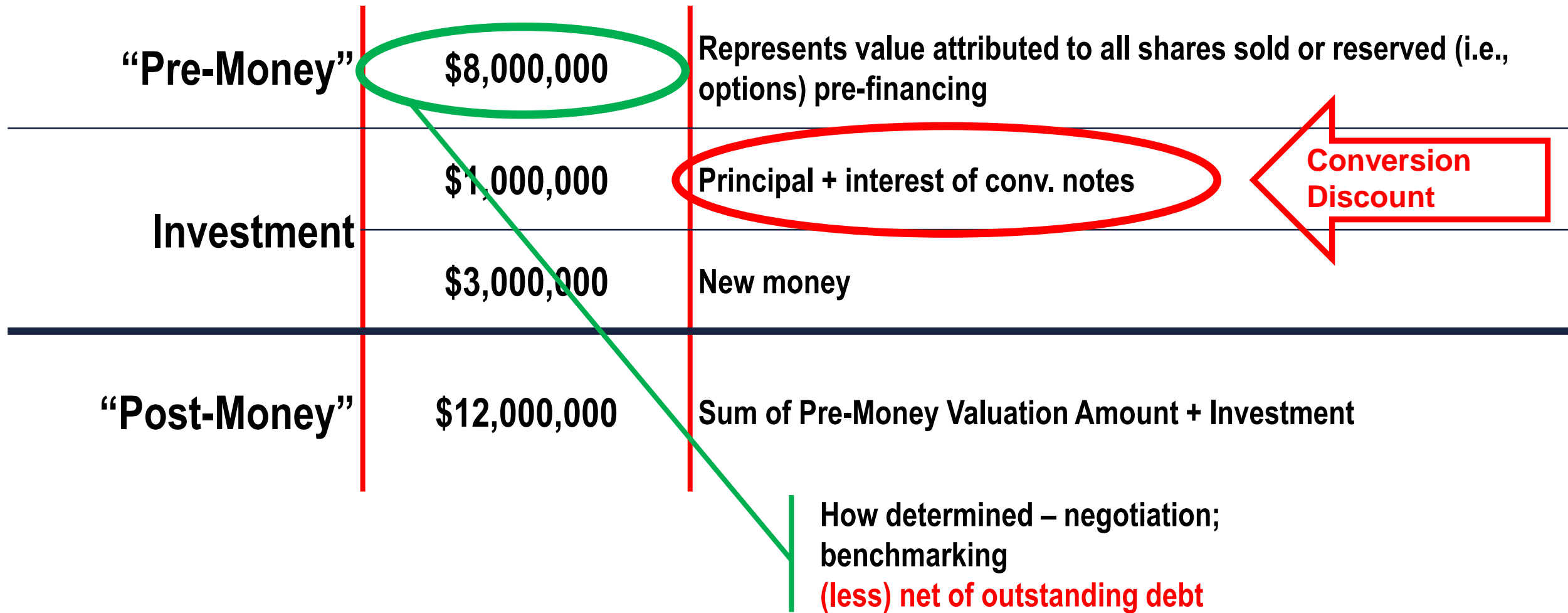
<b>Term</b>	<b>Function</b>	<b>Purpose</b>
<b>Liquidation Preference</b>	<b>Return of initial investment (+ dividends) ahead of general distribution to stockholders</b>	<b>Downside protection (if just 1X) Upside benefit (if &gt; 1X)</b>
<b>Anti-Dilution</b>	<b>Downward adjustment of initial issue price 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>

Becoming operational . . .

**Financing**

**valuation**

# Financing (“Pre-Money” & “Post-Money”)



# Financing (variables)

<b>“Pre-Money”</b>	<b>\$8,000,000</b>
<b>Note Conversion Discount</b>	<b>30%</b>
<b>Investor Requirements</b>	<b><i>“Post Money” Cap? (say, \$10M)</i></b>

# Financing (Valuation – “founder friendly” method)

<b>Founders &amp; Option Pool</b>	<b>1,000,000</b>	<b>64.37%</b>
<b>Note Holders</b>	<b>178,571</b>	<b>11.49%</b>
<b>New Investors</b>	<b>375,000</b>	<b>24.14%</b>
<b>Total Issued &amp; Reserved Shares</b>	<b>1,553,571</b>	<b>100%</b>



<b>Series A issue price</b>	<b>\$8.00 (\$8M Pre-Money ÷ (Founder &amp; Option Pool Shares))</b>
<b>Eff. “Pre-Money” Valuation</b>	<b>\$8,000,000</b>
<b>Eff. “Post-Money Valuation</b>	<b>≈ \$12.43 million (Total Shares × Series A issue price)</b>


# Financing (Valuation – “investor friendly” method)

<b>Founders &amp; Option Pool</b>	<b>1,000,000</b>	<b>55.71%</b>
<b>Note Holders</b>	<b>256,407</b>	<b>14.29%</b>
<b>New Investors</b>	<b>538,455</b>	<b>30.00%</b>
<b>Total Issued &amp; Reserved Shares</b>	<b>1,794,862</b>	<b>100%</b>



<b>Series A issue price</b>	<b>\$5.5715 (to meet investor-req. \$10M post-money val.)</b>
<b>Eff. “Pre-Money” Valuation</b>	<b>\$5,571,500</b>
<b>Eff. “Post-Money Valuation</b>	<b>≈ \$10 million (Total Shares × Series A issue price)</b>

# Financing (Valuation – “dollars invested” compromise method)

<b>Founders &amp; Option Pool</b>	<b>1,000,000</b>	<b>63.1%</b>	 <p>Reflects new investment as % of post-money</p>
<b>Note Holders</b>	<b>188,677</b>	<b>11.9%</b>	
<b>New Investors</b>	<b>396,223</b>	<b>25%</b>	
<b>Total Issued &amp; Reserved Shares</b>	<b>1,584,900</b>	<b>100%</b>	



<b>Series A issue price</b>	<b>\$7.5715 (to reflect pre-money + aggregate investment)</b>
<b>Eff. “Pre-Money” Valuation</b>	<b>\$7,571,500</b>
<b>Eff. “Post-Money Valuation</b>	<b>≈ \$12 million (Total Shares × Series A issue price)</b>



Return on investment . . .

**Financing**

**outcomes**

# Preferred Stock -- 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**

# Participation Cap “Indifference” – Series C Distribution

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

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

Reaching the finish line . . .

**Financing**

**waterfalls**

# EXIT (payout “waterfall”)



Liquidation Preference Distribution

# Liquidation Waterfall -- \$20M Exit, Participating Preferred

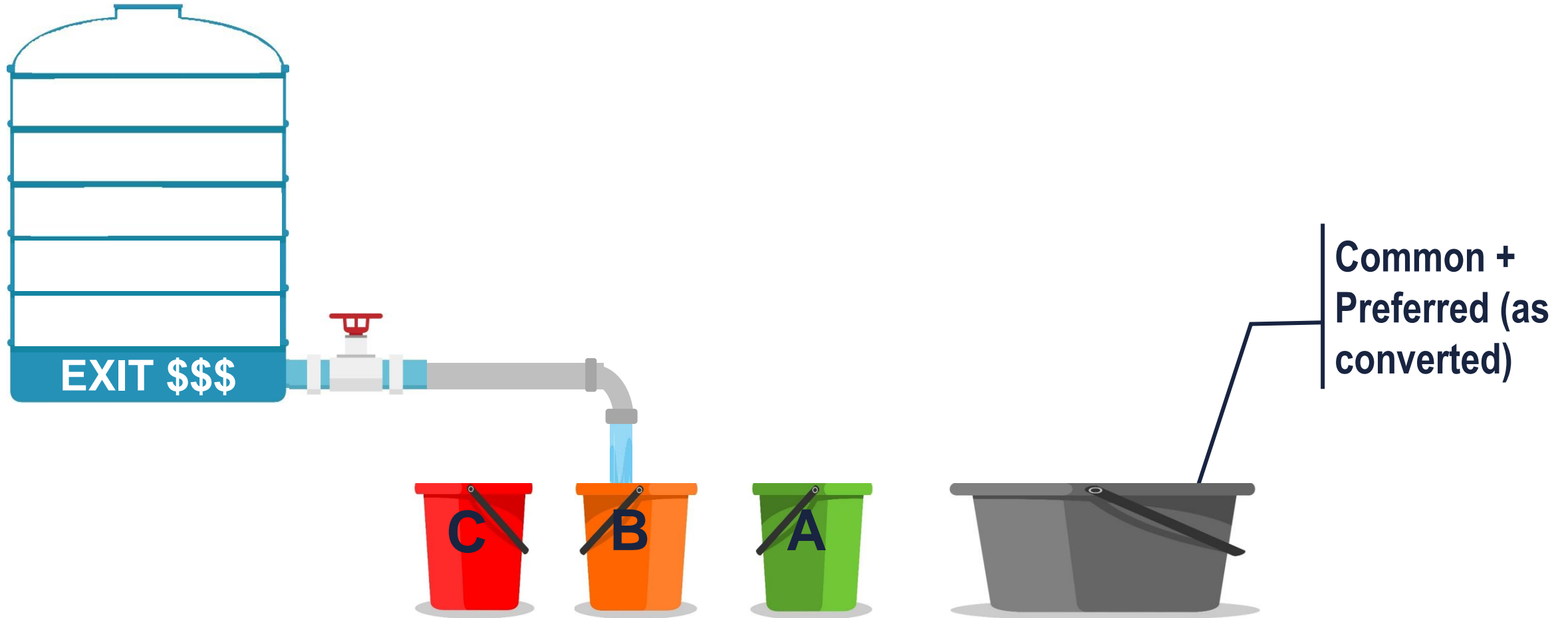
<b>Exit Proceeds</b> (amount remaining after payment of outstanding debt, etc.)		<b>\$20,000,000</b>	<b>Remaining After Payout</b>
<b>Liquidation Preference Payouts</b>	<b>Series C</b>	<b>\$15,000,000</b>	<b>\$5,000,000</b>
	<b>Series B</b>	<b>\$10,000,000</b>	<b>\$0 (only ½ of Payout made)</b>
	<b>Series A</b>	<b>\$5,000,000</b>	<b>\$0</b>
<b>Net Exit Proceeds</b> (amount to be distributed to Common + Participating Preferred on pro rata basis)			<b>\$0</b>

# EXIT (payout “waterfall”)



Liquidation Preference Distribution

# EXIT (payout “waterfall”)



Liquidation Preference Distribution



# Liquidation Waterfall -- \$120M Exit, Participating Preferred

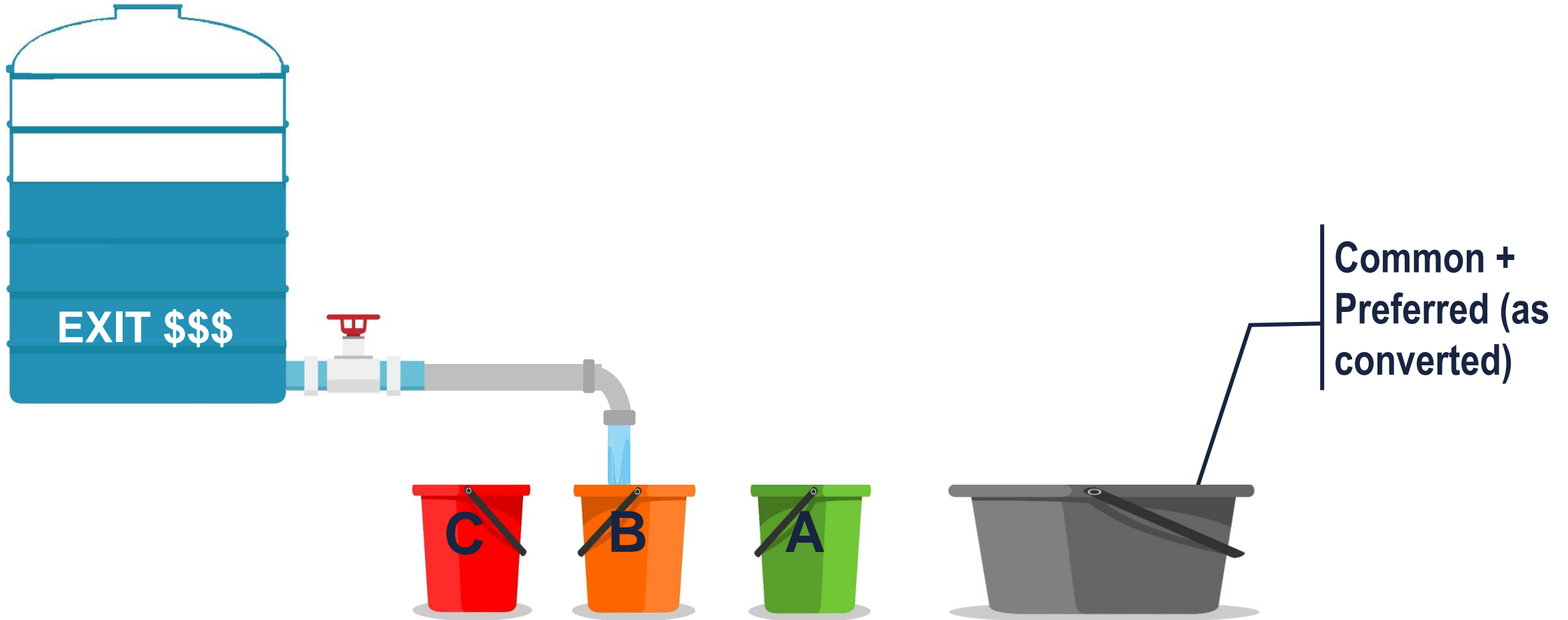
<b>Exit Proceeds</b> (amount remaining after payment of outstanding debt, etc.)		<b>\$120,000,000</b>	<b>Remaining After Payout</b>
<b>Liquidation Preference Payouts</b>	<b>Series C</b>	<b>\$15,000,000</b>	<b>\$105,000,000</b>
	<b>Series B</b>	<b>\$10,000,000</b>	<b>\$95,000,000</b>
	<b>Series A</b>	<b>\$5,000,000</b>	<b>\$90,000,000</b>
<b>Net Exit Proceeds</b> (amount to be distributed to Common + Participating Preferred on pro rata basis)			<b>\$90,000,000</b>

# EXIT (payout “waterfall”)



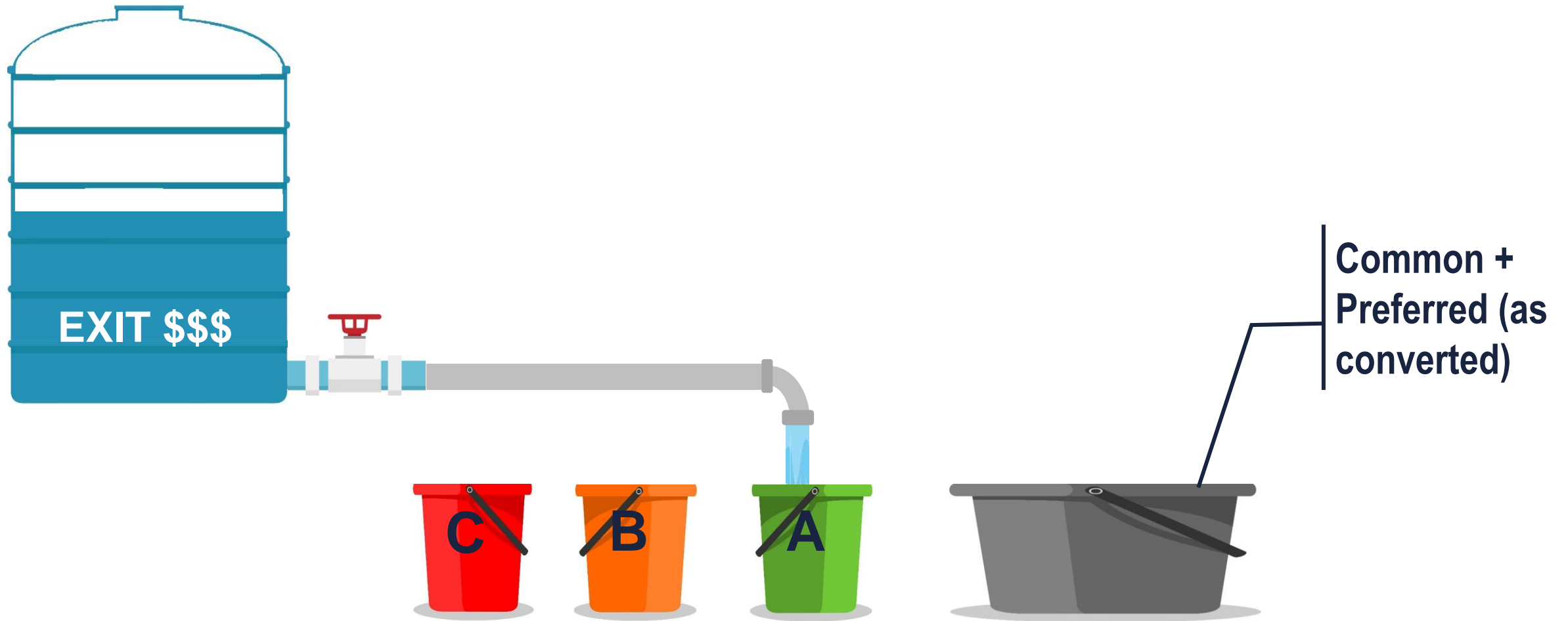
Liquidation Preference Distribution

# EXIT (payout “waterfall”)



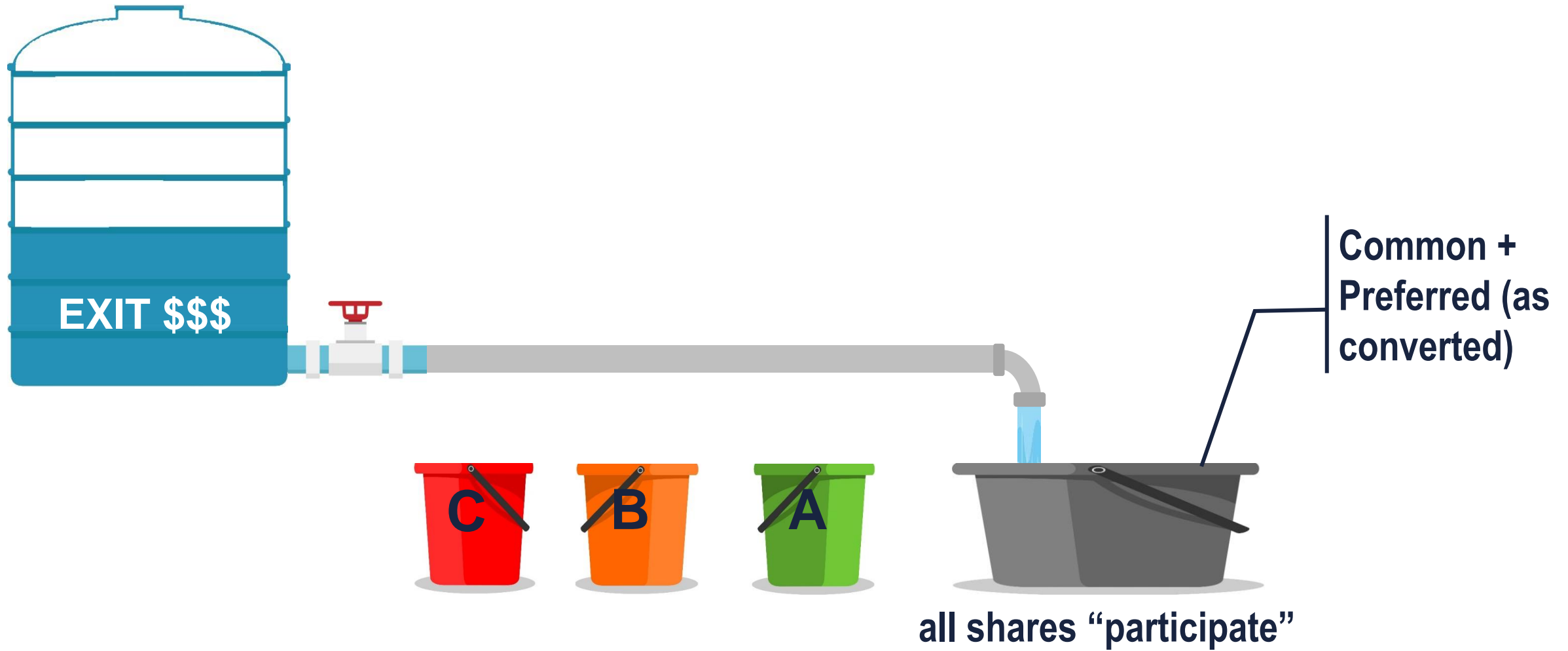
Liquidation Preference Distribution

# EXIT (payout “waterfall”)



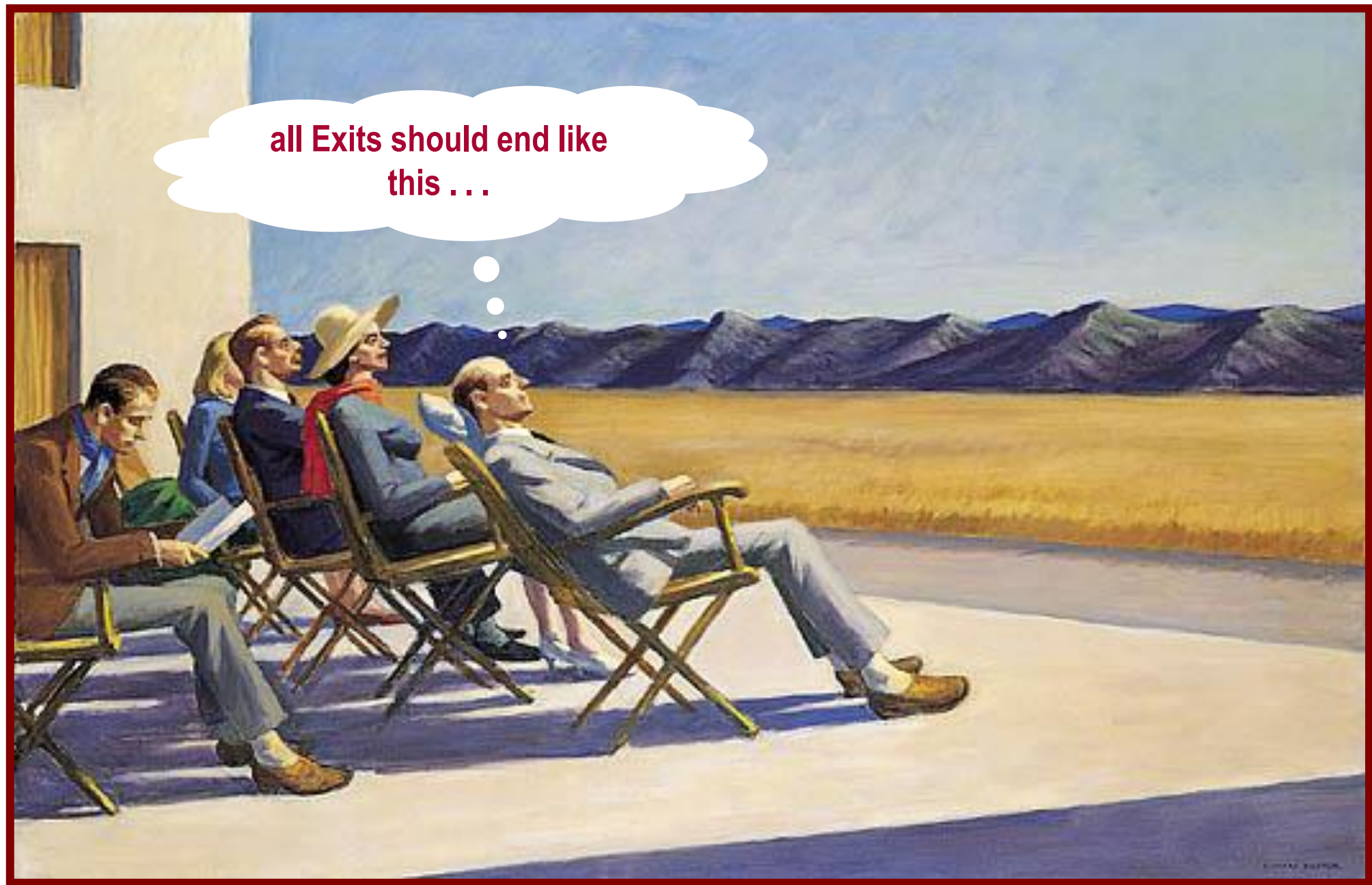
Liquidation Preference Distribution

# EXIT (payout “waterfall”)



# Liquidation Waterfall -- \$120M Exit, Participating Preferred

	<b>% of Issued Shares (as converted to Common)</b>	<b>Liquidation Preference</b>	<b>Distribution of \$90M Net Exit Proceeds</b>	<b>Total Distribution (~% of Exit)*</b>	<b>ROI</b>
<b>Series C</b>	<b>35%</b>	<b>\$15,000,000</b>	<b>\$31,500,000</b>	<b>\$46,500,000 (38.75%)</b>	<b>3.1X</b>
<b>Series B</b>	<b>25%</b>	<b>\$10,000,000</b>	<b>\$22,500,000</b>	<b>\$32,500,000 (27.09%)</b>	<b>3.25X</b>
<b>Series A</b>	<b>10%</b>	<b>\$5,000,000</b>	<b>\$9,000,000</b>	<b>\$14,000,000 (11.66%)</b>	<b>2.8X</b>
<b>Common</b>	<b>30%</b>	<b>N/A</b>	<b>\$27,000,000</b>	<b>\$27,000,000 (22.5%)</b>	<b>??X</b>



Thank you