



RICHARD IVAR RYDSTROM ATTORNEY AT LAW

RYDSTROM LAW OFFICE

4695 MacArthur Court 11th Floor

Newport Beach, California 92660

1-877-Win-4-You™

(Tel) [949.678.2218](tel:949.678.2218) | (Fax) [949.606.9716](tel:949.606.9716)

www.RydstromLaw.Com

Richard Rydstrom, Esq. | 949.678.2218 (Direct Dial)

Los Angeles; Newport Beach;

Silicon Valley; San Diego; California

rich@rydstromlaw.com

January 1, 2020

Startups, Funding & Growth Cheat Sheet - General Counsel Primer

Warning/Limited Scope: Offers and Sales of equity in a company are subject to the U.S. Securities and Exchange Commission, and applicable state Blue Sky laws (“SEC LAWS”). All securities must be registered or exempt. Violations or failure to register or comply may result in civil and or criminal consequences. Intentional misstatements or omissions of fact constitute federal criminal violations. See 18 U.S.C. 1001. Regulation D compliance offers a ‘Safe Harbor’ exemption (e.g.: 506(b)). This cheat sheet deals only with private companies which may require a filing of the Regulation D form, not registered public companies or Initial Public Offerings (“IPOs”).

Founders, Friends, Family and Investors: Typically, when starting a company, an entity is formed. Whether you form a business corporation or limited liability company, the funding of a business is subject to SEC LAWS.

Founders Stage: Although there is no legal designation of “founders’ stock”, it is an important concept. First, it may lessen litigation liability, as well as exposure to registration under the SEC LAWS. For example, you may fashion the *collective* origination documents (e.g.: operating agreement, bylaws, restricted or founder’s equity purchase agreement, etc.), with the founders as parties thereto. Therefore, each party is (equally) responsible for the collective information, promises, projections, dreams, and formation, often limiting the potential liability (claims) of same among those parties. Also, one exemption to the requirements of the ‘accredited’ investor status, is directors, executive officers and partners of the company. This is important because an otherwise ‘unaccredited’ investors is deemed ‘accredited’ investors as founders: directors, executive officers, partners, or controlling persons, or managers (Reg D 501(a)). This is important as compliance with some Reg D exemptions may require only ‘accredited’ investors, or no more than 35 ‘unaccredited’ investors.

Overview of Founders’ Special Terms: Moreover, Founders do often grant special rights for Founders’ Stock including provisions re Vesting, Accelerated Vesting and Triggers (sale of

company; resignation or termination from company; etc.), Right of First Refusal, Co-Sale, Lock-Up, Super-Voting Rights, etc. Founders should consider implementing these provisions prior to the Investor Stage funding, as experienced investors may require much more onerous provisions against a Founder who leaves.

Vesting: Founders Stock is often conditioned on a vesting schedule. Typically, monthly or quarterly, in 4-year increments. For example, if a founder resigns before vesting 100% of said Founders Stock, the company has the first right of refusal to buy-back that Founders Stock at cost or a fair market valuation or a multiple thereof. Vesting can supply a tax benefit for founders under IRC 83(b). This allows a tax election of a lower or founders' valuation (i.e.: .0001 par value), prior to the vesting of all such stock at possibly higher valuations (over time).

Protections can be included for Founders for unfair terminations *without cause* or triggers such as the sale of the company. Founders can accelerate vesting upon death or incapacity.

Trigger Vesting Acceleration: A single trigger accelerates vesting of a percentage or all of the unvested Founders Stock upon Company Sale, releasing the founder employee of Golden Handcuffs. A double trigger accelerates vesting of a percentage or all of the unvested Founders Stock at Company Sale, and the unfair termination without cause within a period of years after the Closing of Company Sale, locking the Golden Handcuffs. A Good Reason Clause may allow the Founder to leave the company with accelerated vesting of a portion or all of the unvested stock.

Cliffs: The vesting may be further conditioned by a cliff period before the vesting is implemented ("Cliff"). Commonly, founders are given credit for prior work, and no Cliff is imputed, or typically a 1-year Cliff requires the founder to be with the company for one year prior to the vesting implementation (Retroactive Cliff Credit").

Company First Right of Refusal: The company (then other founders, then other investors) may fashion a first right of purchase refusal of Founders Stock. These provisions can be in the Bylaws, Operating Agreements, etc.

Co-Sale Rights: The right to sell Founders Stock may be agreed by the founders. Who and by what terms, are subject to negotiation to define who is favored in the co-sale rights, e.g.: other Founders, investors, etc.

Lock Up Clause: The lock up provision restricts the sale of stock following typically 180 days or more after an IPO.

Super Voting Control Shares: It is not uncommon to issue a separate class of stock to founders with super voting or disproportionate share voting rights over the other shares of stock. Such is usually 7- or 10-times greater votes per Founders Share. Investors may object to same as investors may not be willing to believe-in said Founders to grant such power.

Investor Stage: Moreover, when investors fund a company, they do so at various stages in various investment vehicles. For example, Seed Funding, Series A (Common Stock), Series B (Common or Preferred Stock), Options, Convertible Debt (Into equity) Agreement, etc. Investors are categorized as either 'sophisticated' (Securities Act of 1933 section 4(2)), 'accredited', or 'unaccredited'. Typically, within 15 days after a Sale, a Regulation D ("Reg D")

form ("Notice of Exempt Offering of Securities") must be filed with the SEC. SEC Form D Link: <https://www.sec.gov/about/forms/formd.pdf>

Sophisticated Investor: A Sophisticated Investor under the Securities Act of 1933, Section 4(2), has the knowledge and experience to evaluate the investment, bear the risk of loss of the investment, is entitled to all information normally disclosed in a formal prospectus, and must agree not to resell or distribute the stock shares/interest to the public.

Unaccredited Investor: An Unaccredited Investor is not an Accredited Investor.

Accredited Investor: An Accreditor Investor is an individual with a net worth which exceeds \$1,000,000 or an individual with income which exceeds \$200,000 per year over the last 2 years (\$300,000 with spouse), a director, executive officer, general partner of the issuer company (much like the typical founders (directors, executive officers/employees, partners, or controlling persons, or key managers), an employee benefit plan under ERISA, broker-dealer (under Section 15 of Securities Exchange Act of 1034), bank, insurance company, or (small) business development company, a trust (with assets over \$5,000,000), a government employee benefit fund, an exempt 501(c)3 (with assets over \$5,000,000), an Accreditor owned entity, etc.

Exemptions: The Issuer company is required to file the Reg D form within 15 days after the first sale of securities. The following is the form found at:

<https://www.sec.gov/about/forms/formd.pdf>

| | | |
|---|--|---|
| FORM D Notice of Exempt Offering of Securities | U.S. Securities and Exchange Commission Washington, DC 20549 (See instructions beginning on page 5) | OMB APPROVAL OMB Number: 3235-0076 Expires: March 31, 2020 Estimated average burden hours per response: 4.00 |
| Intentional misstatements or omissions of fact constitute federal criminal violations. See 18 U.S.C. 1001. | | |
| Item 1. Issuer's Identity | | |
| Name of Issuer <input type="text"/> | Previous Name(s) <input type="checkbox"/> None <input type="text"/> <input type="text"/> | Entity Type (Select one) <input type="checkbox"/> Corporation <input type="checkbox"/> Limited Partnership <input type="checkbox"/> Limited Liability Company <input type="checkbox"/> General Partnership <input type="checkbox"/> Business Trust <input type="checkbox"/> Other (Specify) <input type="text"/> |
| Jurisdiction of Incorporation/Organization <input type="text"/> | Year of Incorporation/Organization (Select one) <input type="checkbox"/> Over Five Years Ago <input checked="" type="radio"/> Within Last Five Years (specify year) <input type="text"/> <input type="checkbox"/> Yet to Be Formed <input type="text"/> | |
| (If more than one issuer is filing this notice, check this box <input type="checkbox"/> and identify additional issuer(s) by attaching Items 1 and 2 Continuation Page(s).) | | |

Typical Reg D Exemptions:

The issuer must file a Reg D form and identify an applicable exemption (e.g.: 504, 506b, 506c, etc.). It must also file the applicable state notice or exemption. (See California example below). Generally, private offers and sales are exempt if sales (a) do not exceed \$1,000,000 (unlimited number of investors), or (b) sales do not exceed \$5,000,000 with no more than 35 Unaccredited Investors, or (c) sales are made to no more than 35 Sophisticated Investors.

Item 6. Federal Exemptions and Exclusions Claimed (Select all that apply)

- | | | |
|--|--|---|
| <input type="checkbox"/> Rule 504(b)(1) (not (i), (ii) or (iii)) | <input type="checkbox"/> Section 3(c)(1) | <input type="checkbox"/> Section 3(c)(9) |
| <input type="checkbox"/> Rule 504(b)(1)(i) | <input type="checkbox"/> Section 3(c)(2) | <input type="checkbox"/> Section 3(c)(10) |
| <input type="checkbox"/> Rule 504(b)(1)(ii) | <input type="checkbox"/> Section 3(c)(3) | <input type="checkbox"/> Section 3(c)(11) |
| <input type="checkbox"/> Rule 504(b)(1)(iii) | <input type="checkbox"/> Section 3(c)(4) | <input type="checkbox"/> Section 3(c)(12) |
| <input type="checkbox"/> Rule 506(b) | <input type="checkbox"/> Section 3(c)(5) | <input type="checkbox"/> Section 3(c)(13) |
| <input type="checkbox"/> Rule 506(c) | <input type="checkbox"/> Section 3(c)(6) | <input type="checkbox"/> Section 3(c)(14) |
| <input type="checkbox"/> Securities Act Section 4(a)(5) | <input type="checkbox"/> Section 3(c)(7) | |

Common Exemptions & Reg D Safe Harbors:

Reg D 504 (Also Referred to as Seed Funding): Up to \$5,000,000 over 12 months; requires no solicitation (advertising) unless a particular state allows same otherwise therein, and the issuer must comply with state Blue Sky laws for registration or exemption, transfers are restricted unless sold under state exemption (to accredited investors) otherwise. Other restrictions apply.

Reg D 506(b), (4)(a)(2) Compliant (Most Commonly Used Safe Harbor Exemption): Unlimited Amounts: 506(b) is the primary Safe Harbor used for Private Offerings; requires no solicitation (502(c)) or advertising, no more than 35 Unaccredited Investors with unlimited Accredited Investors, transfer is restricted under Rule 144. Issuer does not have to comply with state Blue Sky exemptions. Disclosure of information includes: Financial Statements (like old Rule 505 type), disclosure of all information with opportunity to ask and verify questions/answers. More relaxed verification than 506(c). (Registration or notice may be required) Other restrictions apply.

Reg D 506(c) (Public Solicitation & Limited Advertising Exemption): 506c allows general limited scope public solicitation (advertising) to Verifiable Accredited Investors only, and transfer is restricted under Rule 144. Issuer does not have to comply with state Blue Sky exemptions. (Registration or notice may be required) Other restrictions apply.

Reg A+ Tier 1: Quasi-Public Offering, Tier 1 (max. \$20,000,000/12 months), no restriction on investors, file reports, transfers not restricted, is subject to state Blue Sky laws. Other restrictions apply.

Reg A+ Tier 2: Quasi-Public Offering, Tier 2 (max. \$50,000,000/12 months), no restriction on investors, file reports, transfers not restricted, is subject to state Blue Sky laws. Other restrictions apply.

Crowdfunding: Up to \$1,000,000 over 12 months; Offering must be made on an *approved online portal only*; Form C required; transfers restricted for 12 months after sale; no state Blue Sky law compliance. Investors may only invest small or limited amounts per formulas. Other restrictions apply.

Statutory 4(a)(2): Do not rely solely on 4(a)(2) but a Private Offer and Sale exemption may still be available for non-public offerings (Jumpstart Act of 2012); sophisticated investors, transfers restricted. Other restrictions apply.

Intrastate Exemption: There is an intrastate exemption under SEC Rule 147 (147A) for issuer company primarily doing business in one state with investors from that state. Other restrictions apply.

Information Disclosure: The issuer company must disclose all material information necessary to protect the investing public. (17 Code Fed Reg 230.502(b)). Generally, the goal is to comply with a particular (Reg D) exemption or otherwise have the option to argue that you also comply by another section. Therefore, in practice, Accredited Investors are the sole desire, but if Unaccredited Investors are necessary, do not allow more than 35. Qualification questionnaires are mandatory to document (and verify) the status of investors, including Sophisticated Investors. The burden is on the Issuer company to prove its compliance with an applicable exemption. Likewise, it is better to disclose to all investors all information that is required for Accredited Investors. Unaccredited Investors and Sophisticated Investors should be given all information given to the Accredited Investors. (17 Code Fed Reg 230.502(b)(2)(iv)). This includes, a written prospectus type document or Private Placement Memorandum (PPM), Financial Statements, Investors Questionnaire, Subscription/Purchase Agreement, with a list of the risks and assumptions, forward looking projections and warnings of/for the investment. This is advisable also as a defense to fraud claims or lawsuits. However, this disclosure is not required under law if less than \$1,000,000 is offered or sold to only Accredited Investors. (17 Code Fed Reg 230.504, 502(b)(1)) The investor is entitled to the opportunity to ask questions, receive answers and verify the information. (17 Code Fed Reg 230.502(b)(2)(v))

What is a Security: A security is any offering or sale of an equity or debt instruments, including Convertible Debt notes, LLC Interests, Options, and corporate Stock shares. Note that the contractual grant of options is a security. Arguably, a conditional or qualified option to obtain a certain right which may or may not be realized, akin to a contingent contract right triggered on an event which has not occurred or may not occur, or a phantom right, a right to receive a bonus or payment upon a certain event, which is not an unconditional promise to receive or convert to equity, or a terminable right upon conditions or events, with no value transferred, may not be deemed a security. But, when in doubt, assume it is a security and comply with a registration or exemption with notice/registration. The Reg D form will require that you identify the Type of security as follows:

Item 9. Type(s) of Securities Offered (Select all that apply)

| | |
|--|--|
| <input type="checkbox"/> Equity | <input type="checkbox"/> Pooled Investment Fund Interests |
| <input type="checkbox"/> Debt | <input type="checkbox"/> Tenant-in-Common Securities |
| <input type="checkbox"/> Option, Warrant or Other Right to Acquire Another Security | <input type="checkbox"/> Mineral Property Securities |
| <input type="checkbox"/> Security to be Acquired Upon Exercise of Option, Warrant or Other Right to Acquire Security | <input type="checkbox"/> Other (describe) <div style="border: 1px solid black; height: 40px; width: 100%;"></div> |

Item 10. Business Combination Transaction

Is this offering being made in connection with a business combination transaction, such as a merger, acquisition or exchange offer? Yes No

Clarification of Response (if necessary)

California State Example: For example, in California, the Limited Offering Exemption allows offers and sales to no more than 35 sophisticated investors such as family, friends, and business associates. Ca Corp Code 25102(f)(1), CHAPTER 1. Exemptions and Certain Securities and Transactions Not Subject to Qualification [25100 - 25105] (Heading of Chapter 1 amended by Stats. 1997, Ch. 391, Sec. 4. 25102; The following transactions are exempted from the provisions of Section 25110:

(f) Any offer or sale of any security in a transaction (other than an offer or sale to a pension or profit-sharing trust of the issuer) that meets each of the following criteria:

- (1) Sales of the security are not made to more than 35 persons, including persons not in this state.
- (2) All purchasers either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or managers (as appointed or elected by the members) if the offeror is a limited liability company, or by reason of their business or financial experience or the business or financial experience of their professional advisers who are unaffiliated with and who are not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly, could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction.
- (3) Each purchaser represents that the purchaser is purchasing for the purchaser's own account (or a trust account if the purchaser is a trustee) and not with a view to or for sale in connection with any distribution of the security.
- (4) The offer and sale of the security is not accomplished by the publication of any advertisement.

(h) Any offer or sale of voting common stock by a corporation incorporated in any state if, immediately after the proposed sale and issuance, there will be only one class of stock of the corporation outstanding that is owned beneficially by no more than 35 persons, provided all of the following requirements have been met:

- (1) The offer and sale of the stock is not accompanied by the publication of any advertisement, and no selling expenses have been given, paid, or incurred in connection therewith.
- (2) The consideration to be received by the issuer for the stock to be issued consists of any of the following:
 - (A) Only assets (which may include cash) of an existing business enterprise transferred to the issuer upon its initial organization, of which all of the persons who are to receive the stock to be issued pursuant to this exemption were owners during, and the enterprise was operated for, a period of not less than one year immediately preceding the proposed issuance, and the ownership of the enterprise immediately prior to the proposed issuance was in the same proportions as the shares of stock are to be issued.
 - (B) Only cash or cancellation of indebtedness for money borrowed, or both, upon the initial organization of the issuer, provided all of the stock is issued for the same price per share.
 - (C) Only cash, provided the sale is approved in writing by each of the existing shareholders and the purchaser or purchasers are existing shareholders.
 - (D) In a case where after the proposed issuance there will be only one owner of the stock of the issuer, only any legal consideration.

(3) No promotional consideration has been given, paid, or incurred in connection with the issuance.

Finders Fees: Be aware that generally an issuer cannot promise or pay finder fees for someone finding investor unless that person/entity has a license. For example, a *licensed Broker Dealer* may do so. However, in California there is a limited one-time type “permit” exception, but note certain contracting investors may not allow it, and certain exemptions may not allow it. See California Section 25110 (h) (3), etc. Also, if the finder is a director, executive officer or partner of the issuer, equity may be granted otherwise.

WARNING AND DISCLOSURE: THIS IS A COMPLEX AREA OF THE LAW WITH CIVIL AND CRIMINAL PENALTIES. YOU MAY NOT USE OR RELY UPON THIS NON-EXHAUSTIVE CHEAT SHEET TO OFFER OR SELL SECURITIES OR DETERMINE EXEMPTIONS. YOU MUST RETAIN A SECURITIES ATTORNEY TO PROTECT YOUR INTEREST.

Richard Rydstrom, Esq. | 949.678.2218 (Direct Dial)
Los Angeles; Newport Beach;
Silicon Valley; San Diego; California
rich@rydstromlaw.com

//