MAKING ANGEL CAPITAL WORK FOR YOU OR YOUR CLIENTS

By Jordan Dolgin

Introduction: While venture capital remains a well publicized source of equity financing for Canada's early stage/growth companies, many companies for a variety of reasons will never receive VC funding. Some are in the "wrong" industries or have too small a "market size" or do not offer minimum VC return rates. However, these companies need additional equity capital to grow and are increasingly turning to "angel" capital once they exhaust traditional "love" money. In many cases, these companies have a number of success attributes and offer patient angel investors the opportunity for solid returns over a 5-8 year time horizon.

Overview: The accounting profession is uniquely positioned to assist their clients (both investors and investee companies) to source, plan, structure and complete angel investments. This short article will highlight a number of angel investing legal considerations with a view to making the process less complex and costly.

Due Diligence: As "due diligence" is central to any major transaction, first consider if your client is "angel ready"? Specifically, are things tidy and organized for review by a proposed angel or is the minute book a disaster, is there outstanding/threatened litigation, do IP ownership issues exist, are their onerous contractual provisions or any other "skeletons" which would deter an angel or give rise to a more complicated transaction? By starting early and using a typical diligence checklist, a number of potential skeletons can either be eliminated or managed before angel discussions commence. The problem with "skeletons" is that they can be used to negotiate a lower enterprise valuation leading to more founder dilution and increasing the overall deal cost to the owners.

Deal Structure: Next comes deal structure. What is the nature of the security and what are the "go-forward" legal obligations relating to control of the business and eventual liquidity of the angel investment? These are critical legal considerations for your clients and can become very involved and complex. Unfortunately, for a $250,000 angel investment, it often does not make sense to have deal terms which give rise to $25,000 of legal and accounting expenses. The basic needs of the parties must be balanced against deal timeline and costs. Obviously, common or preferred share deal is usually cheaper/faster to implement than selling a convertible secured debenture. These "plain vanilla" structures may be ideal in smaller transactions in order to maximize net deal proceeds. Apart from the type of security sold, a new shareholder agreement will need to be negotiated with the founder(s) to deal with control over the business and investment liquidity. There is no such thing as a "standard" shareholder agreement although there are some "minimums" which are common to all shareholder agreements. Again, using a checklist is helpful in identifying these essential elements from the outset. The above discussion presumes the investee is a corporation but it is possible to adopt other angel investment structures (e.g., general/limited partnerships).

Term-Sheet: Usually the needs of the angel will prevail (unless the investee company has a number of competing angels at the table) so it is often incumbent upon the angel to work with its advisors to craft a sufficiently detailed non-binding "term sheet" from the outset. This will have the

advantage of “front-ending” the main deal points and minimizing the number of legal drafts necessary to reach the “end game”. For those companies that are candidates for future VC financing, an angel should expect its “deal rights” will be considerably “diluted” upon completion of any VC round.

Documentation: Following signing the term sheet, the next step is for legal documents to be drafted. To contain legal costs in angel financings, it is critical to involve counsel experienced in angel financing matters and who can assist the parties to front-end as many issues as possible and use appropriate starting templates. In a well-managed process, the first draft of the major legal documents should be 80% complete.

Tax Matters: Tax issues are important to consider as well for the benefit of both investor and investee. For example, a non-resident angel who acquires legal or factual control can jeopardize “CCPC” status and this can adversely impact the target company and its Canadian resident individual founders in a number of ways (e.g., loss of small business deduction, loss of capital gains exemption and reduction of SRED benefits). Separately, the angel may consider using a new class of shares for its investment to avoid any averaging of paid-up capital, etc. Tax advice should be sought at the term sheet stage and tax advisors should review all major deal documents.

Securities Law Issues: While it is not onerous to comply with Ontario securities laws in distributing securities to angel investors who qualify as “accredited investors”, the advice of legal counsel in this area is also important to avoid potential compliance issues. Also, if the angel investor is resident outside Ontario, securities laws in other jurisdictions will need to be considered as well.

Pulling it All Together: As legal counsel, the real trick with angel investing is to address the parties reasonable needs without incurring costs that are disproportionate to the deal size (i.e., often $500,000 or less). However where (a) the investee is “angel-ready”, (b) term-sheets, checklists and proper starting templates are used and (c) as many issues as possible are “front-ended”, it is possible to conclude an angel investment transaction on time and on budget.