BEBCHICK LAW

Law Alert November 2008

Welcome from Bebchick Law

Dear Clients, Colleagues and Friends,

We regularly represent start-up and other early stage companies in raising capital and consummating transactions with potential investors and acquirers. However, several consequences of the current economic downturn, from the drying-up of angel and VC capital to roadblocks in securing borrowed money, are likely to hinder the continued efforts of many companies to obtain funding. Increasingly, companies will be pressed either to engage "finders" who undertake to connect them with new investment sources or to pursue raising interim capital funded by friends and family members.

This Alert briefly address a number of pitfalls that should be avoided when either retaining a "finder" to solicit potential investors or pursuing a "friends & family" round of financing. We hope that you will find this Alert instructive, and we look forward to any questions or feedback that you might have.

Sincerely yours,

Baruch M. Bebchick

Pitfalls to Avoid When Retaining Finders

We regularly are asked to review client agreements with "finders", who typically provide matchmaking and other services with prospective investors or acquirers for a percentage of the financing they secure. The following is a brief description of several pitfalls to avoid in negotiating arrangements with finders:

1. No retainers. A common provision in many finder's agreements is the requirement of a retainer which is paid to the finder (usually on a monthly or other periodic basis) during the term that services are being provided (i.e., until an appropriate investor

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Bebchick Law maintains a vibrant intellectual property and corporate law practice, with a focus on technology, media, marketing, e-commerce, entertainment, software and privacy. Our practice services a broad mix of businesses, from start-ups to public companies, in various stages of development. We regularly counsel clients on how to most effectively organize and reorganize their entities, structure is found and approved by the party engaging the finder). It is a good idea to avoid retainers, and instead to base a finder's compensation on either (i) a flat fee for finding an appropriate investor, or (ii) a percentage of the amount of capital the finder raises for the company. One reason to resist paying retainers is that they often can diminish a finder's incentive to actively pursue investors (compensation based on recurring periodic payments is likely to be less motivating than performance-based compensation). In short, finders should not be compensated unless and until they successfully perform the services for which they have been engaged.

2. No or limited exclusivity. Finders will usually request a period of exclusivity (i.e., that the company retaining them will not seek the services of any other finder). While a period of exclusivity may be reasonable in certain cases, it should be limited in scope and duration so that the company is not prevented from seeking alternative assistance if the finder is not delivering the anticipated results.

3. Approved investment targets. One of the most likely and significant areas for potential disputes with finders is the question of which specific investment targets may be solicited. Companies should ensure that only pre-approved investment targets are solicited by finders, and a list of all such eligible targets should be included in the finder's agreement. In the absence of such a list, a finder may end up soliciting an investment target who has already been approached by the company (or by a third party on the company's behalf). If such a target ultimately invests in the company, the finder may try to claim that its efforts contributed to such a result and that it should be compensated for the investment. Furthermore, if a company prefers that, for whatever reason, a finder refrain from contacting certain investment targets, the company should ensure that such a restriction is memorialized in the finder's agreement.

4. Sole discretion; no representations. Companies must have the right to accept or reject, in their sole discretion, any transaction proposed by a finder or an investor solicited by a finder. While this point seems obvious, it is surprisingly not expressly addressed in some of the finder's agreements we review. Furthermore, the finder's agreement should clearly state that a finder may not make any representation or warranty on behalf of the company.

5. Registered broker/dealer. Companies should be careful to engage only those finders who have registered as a broker/dealer with the appropriate federal and state agencies. Failure to use a registered broker/dealer can have grave consequences for a company. For instance, the involvement of a finder who is not a registered broker/dealer can cause investment or acquisition agreements to be voided, thereby forcing the company involved in such transactions to return the full amount of the investment it has received. Furthermore, the involvement of an unregistered broker/dealer may hinder a company's future fundraising efforts by

entrepreneurial ventures, and commercially protect and exploit their intellectual property and other assets. We also negotiate and draft the full spectrum of agreements necessary to effectuate these and related transactions.

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precluding the use of securities exemptions in additional rounds of financing. Note: in the event that you do decide to engage a finder who is an unregistered broker/dealer, you may be able to minimize some of the potential adverse affects of such an engagement by (i) limiting the services of such a finder to making introductions to investment targets only, (ii) ensuring that such a finder is not involved in any manner in providing ancillary services (such as helping to negotiate the terms of the transaction documents), and (iii) paying the finder a flat fee for its services rather than a fee based on a percentage of the financing raised.

While engaging a finder may be a good way to help raise the capital your company needs, being mindful of the pitfalls outlined above should assist in establishing a sound relationship with a finder.

If you have any questions about any of the items discussed in this Alert or otherwise regarding the engagement of finders, please contact Baruch M. Bebchick at (646) 688-4375 or Email Us.

Friends & Family Financings

Raising a "friends & family" round of financing is often an effective means of obtaining a much needed infusion of cash until a follow-on investment by an angel investor or VC can be secured. However, entrepreneurs can be susceptible to falling into several common traps when dealing with friends and family members, some of which may damage important personal and business relationships and otherwise negatively impact their businesses.

There are several advantages to soliciting friends and family members as investors when other sources of capital are unavailable. Many of these investors will feel a personal (as well as a business) incentive to contribute to an entrepreneur's success, due to a close, pre-existing personal relationship. Friends and family members also often do not require having the involvement in, and control over, a company that most angel investors or VCs commonly insist upon. Moreover, investors who are friends or family members may more readily agree to a higher company valuation than would professional investors (who are more likely to play hard ball regarding valuation), so that ultimately an entrepreneur with such support will likely be giving a smaller portion of the company's equity to investors.

That said, there are significant potential pitfalls in soliciting an investment from friends and family members. Here is a short list of some of these pitfalls and a few suggestions about how they can be avoided:

1. Treat as others. One of the best ways to mitigate potential problems with friends and family members who invest in your business is to treat them in the same fashion as you would treat

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investors with whom you have no prior personal connection. A common mistake made by entrepreneurs is to forego formal documentation with friends and family members. However, disagreements caused by the lack of explicit transaction terms can obviously cause significant legal and business problems and can have a negative effect on important personal relationships. Therefore, be sure to carefully document each of the terms of a potential transaction with friends and family members just as you would with a professional investor. Start by having a solid business plan that is supported by financial statements and a comprehensive term sheet which have been vetted by your accountant, lawyer, and other business advisors.

2. Accredited Investors. Stick with "accredited investors", who are those individuals that either have, at the time of the investment (i) a net worth (including the value of their home) that exceeds $1 million at the time of the investment, or (ii) income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year. In several cases (depending on the nature of the investment), using unaccredited investors can affect the validity of the resulting investment transactions and can significantly limit the parameters by which a company may secure future rounds of financing.

3. Don't oversell. While it is tempting to use your polished "elevator pitch" on friends and family members, it is best to take a more restrained approach. Be conservative in explaining to friends and family members what potential problems may arise that can negatively affect their investment. Remember that these individuals usually are not as sophisticated or seasoned as professional investors and that they are less likely to undertake a formal due diligence process in reviewing the company before coming on board. Since friends and family members will be investing in your company largely because of your personal connection with them, be particularly sensitive about spinning facts or figures.

4. Provide written disclosures. Include adequate representations and warranties in all transaction documents which state that your investors (i) have the level of sophistication necessary to understand the potential risks of their investment, (ii) may receive no return on their investment or worse, may lose their entire investment, and (iii) can afford such risks. The key is to make sure, as with professional investors, that you at all times are providing friends and family members with full disclosure of all material facts that could affect their investment.

In sum, while pursuing a "friends & family" round of financing may be a good way to raise money, especially in a down economy, such efforts may also create a host of problems. These can be mitigated to some degree by adhering to the points discussed above.

If you have any questions about any of the items discussed in this Alert or otherwise regarding investments by friends and family members, please contact Baruch M. Bebchick at (646) 688-4375 or Email Us

Bebchick Law offers you a unique combination of benefits: the sophistication of a large New York practice with the specialization of a boutique and the personal attention of a small firm. As our overhead costs are lower than most New York firms, our clients receive greater value for our top-quality legal services.

Our core practice involves intellectual property and corporate matters, with a focus on technology, media, marketing, e-commerce, entertainment, software and privacy. Bebchick Law regularly counsels clients about how to most effectively organize and reorganize, structure entrepreneurial ventures, and commercially protect and exploit their intellectual property and other assets. We pride ourselves at bringing you value added services - whether by crafting practical solutions to your legal and business problems or by providing sound advice of how to minimize risk and prevent problems in the first instance - in a skillful and efficient manner.

We invite you to learn more about us at Website.

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