



## CORPORATE

# Heaven Sent — Raising Capital From an “Angel Investor”

By Joseph V. Cuomo

When an entrepreneur starts a company with plans of fast growth, there is almost always an immediate need for additional capital. While some founders are capable of financing the new venture on their own (*i.e.*, “bootstrapping”), typically, if the company is going to expand, outside capital will be required. Ideally, at this point, the company will have sufficient revenue and/or public interest so as to attract venture capital funds or other institutional investors. However, there are many instances where, at this stage in the company’s development, the company has not been able to generate much, if any, revenue or public interest. As such, it is often premature for the company to get any serious consideration from the institutional investor community. To bridge the gap, many companies in this position look to “angel investors.”

### Angel investor

The typical angel investor is an individual, as opposed to a company or a fund. Angel investors generally have a high personal net worth, are financially savvy, and

qualify as an “accredited investor” as defined in Rule 501 of Regulation D under the federal Securities Act of 1933. This rule is designed, in part, to provide a minimum baseline of the type of investor best suited to consider, and assume the risks associated with, investing in early stage private companies. In addition, many angel investors are folks that can also add strategic value to the company beyond mere investment dollars. This additional “value” can come in several forms — *e.g.*, mentorship, operational or financial advice, industry connections and expertise. The popular television show “Shark Tank” provides a good illustration of typical angel investors and the types of investments that they may make. For example, billionaire Mark Cuban often chooses to invest in Internet or sports-related startups; two fields that he has had extensive experience and connections in. The ability of a company to attract an angel investor of this stature often provides the company with instant credibility and exposure, which is often much more



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valuable than the actual dollars invested.

### Angel investor financing terms

While there are no hard and fast rules here, most angel investor financings are for under \$1 million and for under a 25% stake in the company. Unlike the typical venture capital financing, which is almost always in the form of preferred stock, most angel deals are for common stock. As such, angel investors stand “shoulder-to-shoulder” with the founders as to the basic economic rights of company ownership.

Angel investors may, however, insist on having certain special non-economic rights (not inherent via their stock ownership) set forth in an investor’s agreement or shareholders agreement. These rights may include: (a) a board seat; (b) board observer rights; (c) voting approval rights over certain fundamental corporate actions, *e.g.*, sale of the business; (d) basic information rights to receive annual and period financial statements and annual

budgets; and (e) inspection rights to view company books and records.

Two of the most valuable rights angel investors often seek is “co-sale” (or “tag-along”) rights and “pre-emptive” rights. Co-sale rights provide the angel investor with the guarantee that if a third party purchases a majority of the company’s equity securities from the founding shareholders, the angel investor will be allowed to participate in the sale. “Pre-emptive” rights guarantee that in the event that the company determines to issue more shares of stock, the angel investor may participate in the new issuance by purchasing that number of new shares so as to maintain the angel investor’s current percentage interest in the company.

Along with the rights provided to angel investors by agreement, angel investors are typically subject to a number of obligations to the company under such agreements. The first, not surprisingly, is a duty of confidentiality. As most angel investors will have some rights to receive and/or have access to sensitive and non-public company information, it is important that such investors be held by contract to a similar standard of

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confidentiality as company officers and directors. Complimentary to co-sale rights are “drag along” obligations. Under a drag-along provision, if the founders desire to sell a majority of the company’s stock to a third party, such founders can force the angel investor to sell as well.

Many angel investor agreements will have restrictions on the angel investor’s ability to sell or transfer his or her shares, which absent such contractual restrictions are generally freely tradable. To that end, perhaps two of the most significant obligations imposed on angel investors are the company’s “right of first refusal” and the company’s “call” right. A “right of first refusal” is a form of transfer restriction that provides that if the angel investor chooses to sell any shares to a third party, the company (or sometimes the founders too) will have the contractual right (but not the obligation) to purchase said shares, either at a pre-determined price or by matching the price negotiated with the third party.

Less often, sometimes angel investors are also subject to a company “call right” — which is the right to purchase (or call in) the angel investor’s shares, under certain circumstances and conditions and under pre-defined terms. Angel investors may resist being subject to a call right under a concern that their shares might be “called” just before the company is about to engage in a significant event or experience a tremendous growth in value.

### Typical angel investor deal documentation

An angel investor deal will often include an executive summary, which describes the company in businessman’s

terms and provides basic historical and projected financial disclosure. This document may also take the form of a full-blown business plan or short “teaser.” There is usually some kind of purchase agreement to cover the terms and conditions of the stock purchase. The purchase agreement is commonly the document under which each of the company and the angel investor gives the other certain representations and warranties. The angel investor’s stock certificate will be a deliverable under the purchase agreement. There will almost always be an investor’s agreement or shareholders agreement (if the company is a corporation, or an operating agreement if the company is an LLC). This agreement will set forth the special rights and obligations of the parties discussed above.

While there is no set formula for what an angel investor financing will look like, and each one is unique like a snowflake, this article summarizes and examines some of the common elements. For startups that have outgrown the founder’s garage, but have not yet attained the revenue stream or public adoration prized by venture capitalists, an angel investor is often the perfect fit.

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