

Legal Basics for Start-Ups

January 14, 2020

Venture Law Meetup Series in Conjunction
with the 2020 J.P. Morgan Healthcare Week



Squire Patton Boggs

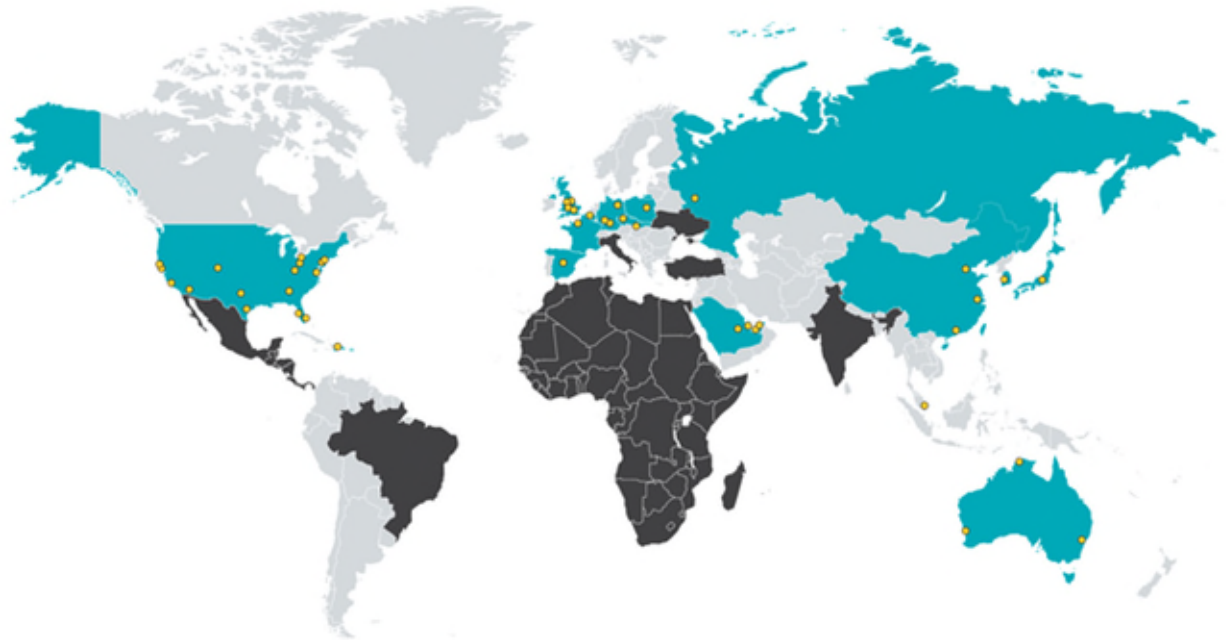
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Regional Desks and Strategic Alliances

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- Squire Patton Boggs Locations
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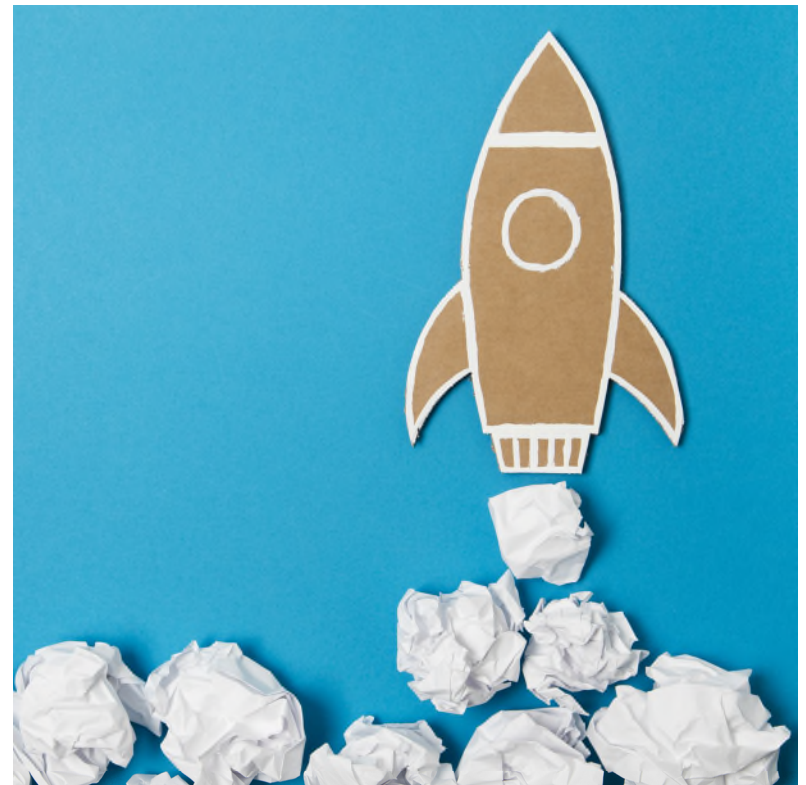
More than 1,500 lawyers in 44 offices across 19 countries on five continents

Today's Program

8:30 a.m.	Registration & Networking
9 a.m.	Top 10 Legal Mistakes That Your Start-up Should Not Make
10:15 a.m.	Employment Issues for Start-ups
11:30 a.m.	IP Strategies to Drive Your Start-up's Success
12:30 p.m.	Lunch and Networking
1:30 p.m.	Workshop: Negotiating Term Sheets Related to Venture Capital Investments
3 p.m.	Networking Reception

Top 10 Legal Mistakes That Your Start-up Should Not Make

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1. Postponing Proper Legal Action and Advice

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Legal Mistakes That Your Start-up Should Not Make: Postponing Proper Legal Action and Advice

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2. Making Legal Solutions Too Complicated

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Legal Mistakes That Your Start-up Should Not Make: Making Legal Solutions Too Complicated

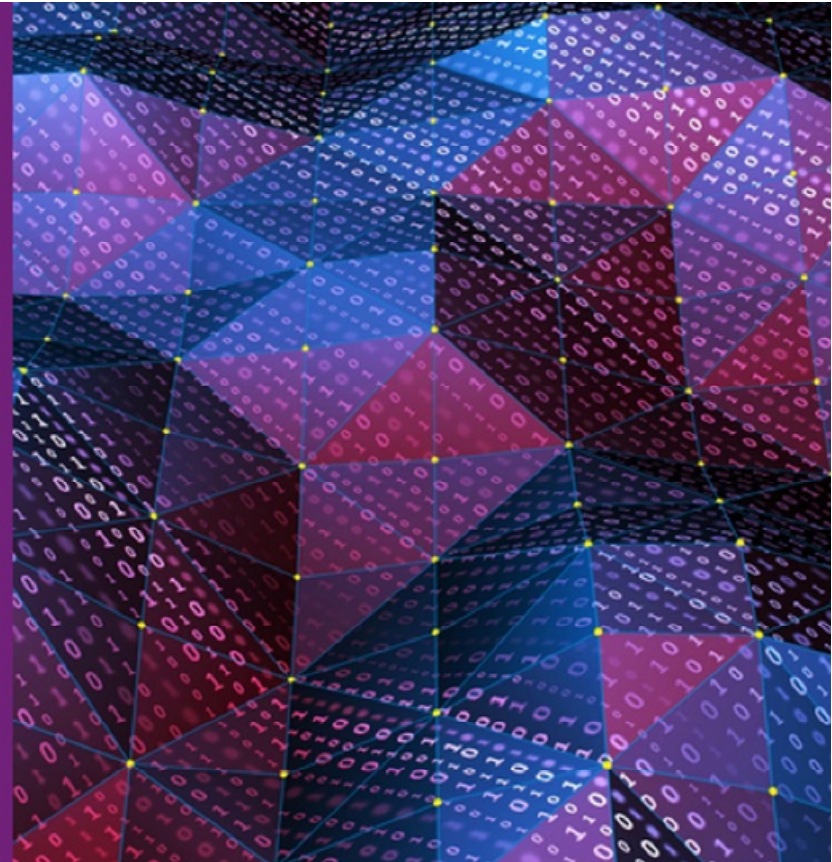
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3. Failing to Identify Intellectual Property and Protect It

Legal Mistakes That Your Start-up Should Not Make: Failing to Identify IP and Getting Protection

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4. Making Improper Use or Untimely Disclosure of Confidential Information

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**Legal Mistakes That Your
Start-up Should Not Make:**
Making Improper Use or
Untimely Disclosure of
Confidential Information

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5. Not Having Proper IP Assignments or Rights

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**Legal Mistakes That
Your Start-up Should
Not Make:** Not Having
Proper IP Assignments
or Rights

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6. Not Incorporating Early



Legal Mistakes That Your Start-up Should Not Make: Not Incorporating Early

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7. Improper or Unwise Issuance of Shares



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**Legal Mistakes That
Your Start-up Should
Not Make:** Improper
or Unwise Issuance
of Equity

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8. Lack of Proper Written Agreements

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Legal Mistakes That Your Start-up Should Not Make: Lack of Proper Written Agreements

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9. Non-compliance With Employment Laws



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**Legal Mistakes
That Your Start-up
Should Not Make:**
Non-compliance With
Employment Laws

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10. Over-promising to Investors

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Legal Mistakes That Your Start-up Should Not Make: Over-promising to Investors

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Employment Law Basics

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- Labor and employment law covers a broad scope, and there is no “one size fits all” approach.
- Determine how your organization prioritizes:
 - Recruitment and Retention
 - Legal Compliance and Expenses vs. Risk Tolerance
 - Intellectual Property
- Understand your workforce:
 - Current workforce’s skillset, needs, expectations
 - Desired future workforce
 - Work locations
- Employment laws are increasingly fractured with rules changing by state and now even by city.

Employee vs. Independent Contractor Issues (Misclassification)

- Considerable legislative and judicial attention due to gig economy now spilling over to other companies.
- Common problems arising from contractor misclassification
 - Wage and hour violations
 - Failure to secure appropriate insurance and pay taxes
 - Inadvertent failure to comply with laws regarding discrimination, retaliation, leave, and other applicable employment laws
 - Not maintaining necessary employment records
- Key questions for determining employment status
 - How much control does the organization exercise over the worker?
 - Is the work outside the usual course of the hiring entity's business?
 - Does the worker provide similar services to other organizations?
 - Does an exception to the test apply?

Why Should I Care About Wage & Hour Issues?

- Avoid costly class or collective actions by employees
 - Over a recent ten-year period, the median average settlement of a wage and hour case was \$2.2 million, and the mean average was \$6.9 million
 - Technical violations can trigger substantial penalties, interest and the obligation to pay the employees' attorneys' fees
- Avoid government investigations, which can raise other issues
- Morale Issues

1. Employee or Contractor?

- Minimum wage & overtime rules do not apply to independent contractors
- “Right to control” test
- “ABC Test”

2. Exempt or Nonexempt?

- Minimum wage & overtime do not apply to exempt employees
- Exemptions apply to bona fide executive, administrative, or professional employees
 - Salary requirements*
 - Executive
 - Administrative
 - Professional
- It's what they do, not what they are called

*Levels vary by state

Minimum Wage & Overtime

- Federal Minimum Wage
 - \$7.25/hour
- California Minimum Wage
 - 25 or fewer: \$12.00/hour
 - 26 or more: \$13.00/hour
- Los Angeles Minimum Wage
 - 25 or fewer: \$13.25/hour
 - 26 or more: \$14.25/hour
- Palo Alto
 - All: \$15.40
- San Francisco
 - All: \$15.59
- Overtime Pay
 - 1.5 times Regular Rate for all hours over 40 in workweek
 - Daily OT in California and others

Hours Worked

- Employees must be paid for all hours worked
 - Includes, but not necessarily limited to, time spent performing activities primarily for the employer's benefit
- Hours worked must be tracked for non-exempt employees
 - Avoid “automatic” practices (e.g., automatically correcting any early or late entries, or automatically deducting for meals/breaks)
 - Account for any after-hours work time (e.g., making deliveries, completing paperwork)

- Most employees are not covered by contracts and do not expect defined, contractual relationships. The default is at-will employment.
- However, agreements can protect employers in several ways:
 - Non-Competes/Non-Solicits/Other Restrictive Covenants
 - Arbitration Agreements (including class and collective action waivers)
 - Defined Contracts and Benefits to Support Recruitment and Retention
 - Assignment of Inventions

- Employee handbooks and other policies accomplish several purposes:
 - Document legal compliance
 - Establish and clarify expectations
 - Highlight benefits
 - Facilitate objective and consistent treatment of workers
- Key policies to maintain:
 - Anti-harassment **Required in California**
 - No discrimination or retaliation
 - Complaint resolution procedure
 - Leave Policies
 - Social Media and Electronic Communications

Key Hiring Considerations

- Avoid job postings that might indicate a preference against certain protected individuals
 - Example: Seeking “young and dynamic” individuals (age)
- Avoid postings that might inadvertently exclude certain protected individuals (e.g., prohibiting walk-ins, posting exclusively on unique social media sites accessed only by certain groups)
- No questions about protected characteristics, protected activities compensation history or criminal record
- Exercise care during small talk
- Identify any job duties that may be physically strenuous
- Understand how to address requests for disability and religious accommodations
- Background check obligations:
 - Criminal record inquiries
 - Consumer reports and related inquiries
 - Privacy considerations
 - Industry-specific obligations



- Organizations must:
 - Secure unemployment coverage
 - Obtain workers' compensation insurance
 - Display (or distribute) legally required employment posters
 - These include posters regarding wage and hour laws, child labor laws, unemployment benefits, occupational safety, fair employment/no discrimination
 - Notify the state and federal government for tax purposes
 - Document certain basic information for the employee (including name, rate of pay, job classification, pay period, status as exempt or non-exempt from overtime laws)
- Requirements vary by state

IP Strategies to Drive Start-Up Success

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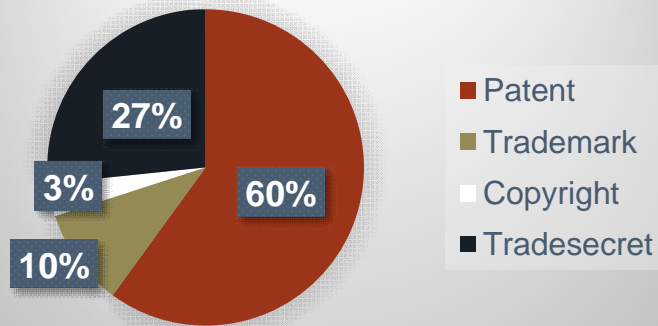


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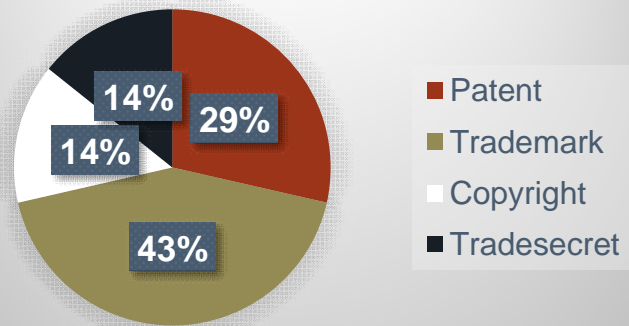
- **Your company's innovations and other intangible assets, are valuable**
 - Important to investors and purchasers
 - Useful in licensing
 - Respected by competitors
 - **How can you protect these intangible assets?**
 - Trademark
 - Copyright
 - Patent
-
- Trade Secret
 - Contract

Your IP Portfolio: What is the Best Mix?

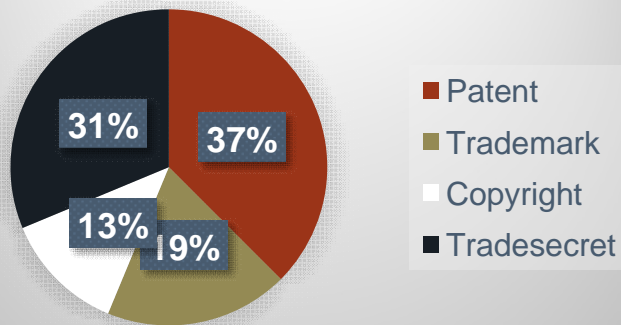
Technical



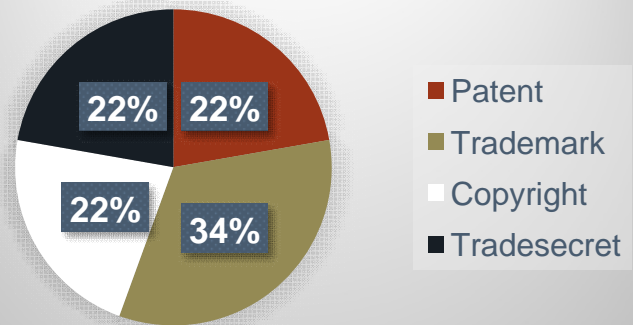
Open Access



Closed Access



Non-Technical



What is a Trademark? Any word, name, symbol, design or slogan used to identify / signify a source and quality of a product

- Selecting a distinctive mark – the “spectrum of distinctiveness”
- Ensuring the mark is available – the importance of clearance searches
 - Avoiding the selection of a potentially infringing mark
- Registering the mark – use based applications v. intent-to-use applications
- Prosecuting the application
- The duration of trademark rights
- Policing your mark



What is a Copyright and What Does it Protect? Works of authorship and expression

- Copyright as a “bundle of rights”
- The absence of formalities
 - Registration and copyright notices
- Who owns the copyright
 - Employees and the “Work-Made-For-Hire” doctrine
 - Contractors and the importance of an assignment
- The duration of copyright
- Copyright and software
 - Demystifying open source



What is a Utility* Patent? A government-issued right to exclude others from practicing your invention

- Requires a patent application that is reviewed on its merits by the PTO
- Lasts for 20 years from the time of filing of the application, assuming no delays in prosecution
- Can eliminate competition
 - Competitors choose not to infringe or pay a license fee
 - Litigation can result in payment of substantial damages
- Design patents protect non-functional designs, and plant patents protect new varieties of plants



1. Patent Preparation

- The specification provides a written description of the invention, and explains the manner and process of making and using it sufficiently to enable someone with skill in the art to practice the invention
- The application includes proposed claims

2. Patent Examination

- Examiner rejects claims that do not meet the patent requirements (e.g. given the disclosure or prior art)
- Applicant can argue or amend the claims in response
- Application is published and public after 18 months

3. Patent Term

- Begins on date of issuance; ends 20 years from the earliest non-provisional filing date

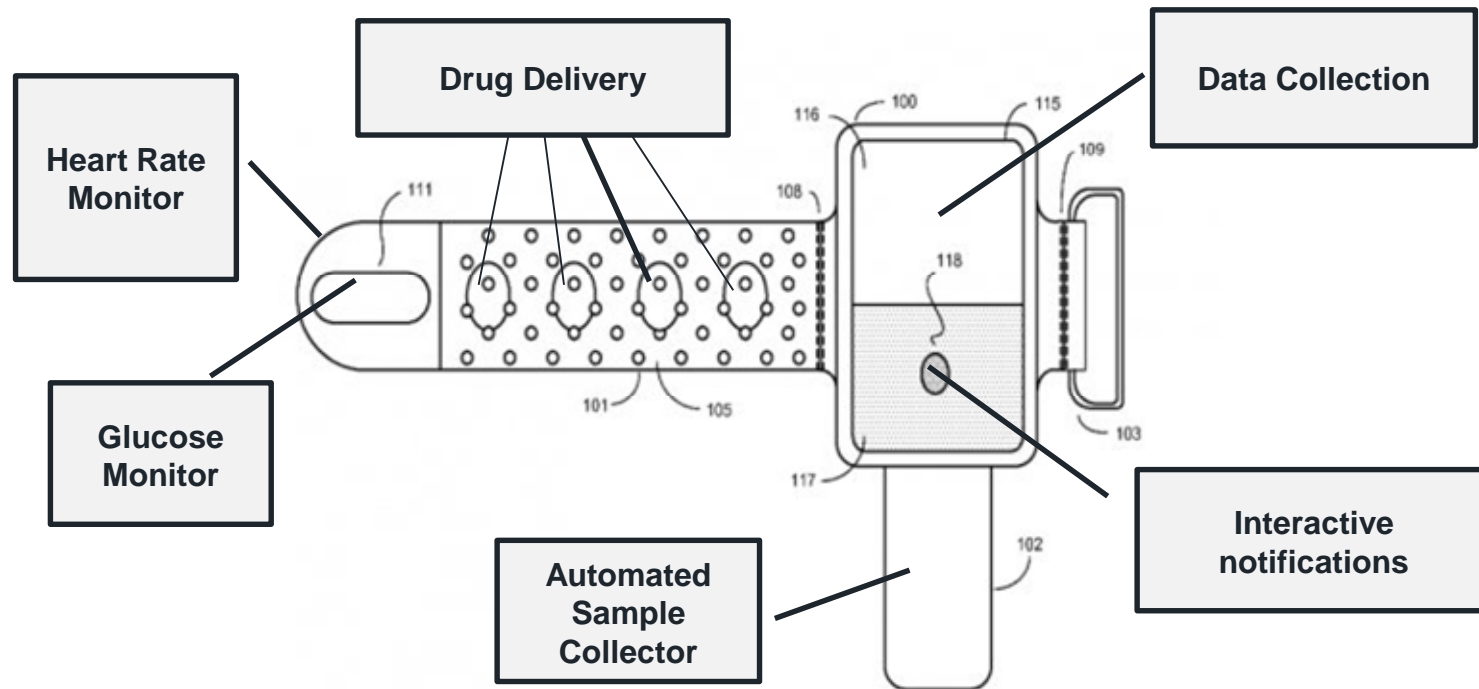
4. Issued Patents Subject to Reexamination or Review

What is a Trade Secret? Information that derives independent economic value from not being generally known, that is the subject of reasonable efforts to maintain its secrecy.

- Infinite duration (*potentially!*)
- Relatively cheap and easy
- Broad range of information protected; complements other forms of protection
- Can be disclosed, via NDA
- Can be used to get injunctive relief
 - Powerful tool against competitors
 - Helpful with departing employees



Hypothetical New Product



Strategic Considerations

Intangible Asset	Trademark	Copyright	Patent	Trade Secret	Contract Provision
Small Molecules	Yes	No	Yes	Maybe	Yes
Med Devices	Yes	No	Yes	No	Yes
Software	Yes	Yes	Maybe	Yes	Yes
Algorithms / AI	Yes	Maybe	Maybe	Yes	Yes
Diagnostics	Yes	Maybe	Maybe	No	No
Clinical Data	Maybe	Yes / No	No	Maybe	Yes
Market Info	Maybe	Yes / No	No	Maybe	Yes
Technical Info	Maybe	Yes / No	No	Maybe	Yes

Who Owns the IP? If your company does not own the IP, it can acquire the IP by an assignment, or get rights to use the IP under a license

- **US Patents:** Ownership vests initially in the inventors – anyone who contributed to any claimed invention in the issued patent
- **Copyright:** For most works, the authors have copyrights, but a company has copyright in works-made-for-hire
- **Trademarks:** Belong to the user of the mark in commerce, but can be registered, which may complicate matters
- Many institutions – e.g. Universities, Labs – automatically own the technology developed with their facilities
- Need to check governing agreements to determine assignments of IP rights

What is a Contractual Provision? A section in a binding agreement between two parties that imposes rights or duties and is legally enforceable

- IP provisions typically included in employment contracts
- Require confidential treatment of company information (not restricted to trade secrets)
- Assign and create obligations to assign any inventions or other IP rights of one party to the other party
- Provide rights to use IP, e.g. a license



Your Signature

- **Subject Matter Eligibility (SME) before the:**
 - US Patent Office and Patent Trial and Appeal Board (PTAB)
 - New guidelines and examples of 7 Jan 2019 and 17 Oct 2019.
 - *Berkheimer* and *Vanda* memos of 19 April 2018 and 7 June 2018.
 - *Ex parte Hannun* (*Ex parte Linden*), Informative (19 Dec 2019) PTAB Decision applying new guidelines and reversing SME rejection of speech transcription.
 - Federal Circuit and Supreme Court
 - *Athena v. Mayo*: Holding diagnostic patent invalid and 7-5 split denying *en banc* review. Supreme Court denied review on 13 Jan 2020.
 - *Cleveland Clinic Foundation*: No *Chevron* deference re USPTO SME guidance.
 - *American Axle & Manufacturing, Inc.*: Method of making drift shaft unpatentable.
 - Legislature
 - Committee action.
 - Election year.

- **LESSON: Focus and distinguish your patent applications**
 - *The Chamberlain Group v. One World Technologies dba Techtronic Industries Power Equip.* (Fed. Cir., Dec. 17, 2019)
 - Appeal from Inter Partes Review finding claims 18-25 of Patent 7,196,611 anticipated, hence invalid, in view of Patent 4,638,433 – both Chamberlain patents
 - Claims were to methods for activating a learning mode based on pre-determined activities of a user; prior patent found to disclose more than one such activity
- **LESSON: Beware potentially infringing activities performed outside the US**
 - *Syngenta Crop Protection v. Willowood et al.* (Fed. Cir., Dec. 18, 2019)
 - Appeal from District Court mixed decision regarding Syngenta's patents on QUADRIS® and QUILT XCEL® fungicides (azoxystrobin)
 - Chinese Willowood defendant manufactured azoxystrobin and US Willowood imported it for testing in the US, but it was unclear where the sale took place
 - 35 USC 271(g) provides that whoever imports or sells in the US a product that is made by a patented process infringes – this does not require that all steps of a patented process be performed by/for single entity

- **LESSON: Do not sell or offer to sell your invention commercially before filing a patent application.**
 - ***Helsinn Healthcare S.A. v. Teva Pharmaceuticals* (U.S. Supreme Court, Jan. 22, 2019)**
 - Helsinn contracted with another company to have them distribute, promote, and sell the invention; 2 years later Helsinn filed a patent application on the invention
 - Even though the invention was never publicly disclosed until the patent application, a secret sale is still a sale and can be a bar to patentability.
 - *Note: If a sale is made primarily for the purposes of experimentation then the sale may not be considered a commercial sale or a bar to patentability.*
- **LESSON: It may not be infringement to use another's patent, depending on the circumstances under which the activity is done.**
 - ***Amgen Inc. v. Hospira Inc.* (Federal Circuit, December 16, 2019)**
 - Amgen's patents covered methods of preparing mixtures of specific EPO variants; Hospira used the methods to make its EPO product before it received FDA approval.
 - "Safe harbor": If the activity was done "solely for uses reasonably related to the development and submission of information" to FDA for the purpose of obtaining approval, then the activity is not an act of infringement; but you can have *other* underlying reasons for using the patented method.

Workshop: Negotiating an Investment Term Sheet

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- This presentation is intended to provide a high level summary, for discussion purposes only, of investment term sheet negotiation
- This presentation simplifies many concepts that include other nuances and details

- Example company
 - Delaware C-corporation
 - Tech company
 - First institutional financing round (i.e. may have received prior funding from friends and family and angel investors)
 - Founder executives
 - Expected company exit is acquisition or IPO

- Closing Date – As soon as practicable
- Investors – Identify lead / co-lead investor in term sheet
- Amount Raised
- Price Per Share
- Valuation
 - Pre-Money Valuation
 - Post Money Valuation
 - Reserve an equity pool
- Capitalization – Attach current cap table
 - Include stock options, RSUs, warrants, convertible notes, SAFEs

“There is no such thing as an absolute value in this world. You can only estimate what a thing is worth to you.”

**Charles Dudley Warner 1829-1900,
American Writer**



Certificate of Incorporation (COI)

- Public Document
- Establishes the rights, privileges and restrictions of the Preferred Stock to be issued in the financing

How do Investors get their investment \$\$ back?

- Dividends
 - None unless declared by Board OR accumulating at X% per year OR not paid unless declared by Board, but amount per share set in advance
- Liquidation Preference – How much an investor is paid when the company is sold or closed (a Liquidation Event)
 - Non-participating Preferred OR fully participating Preferred OR cap on Preferred participation

*What *fundamental* protections do Investors want to protect the value of their investment?*

- Appoint Board Member
 - Series A Director blocking rights
- If X% of Preferred Stock are outstanding, Investors must approve material actions by the Company:
 - Liquidation Event, Amendment of COI, Bylaws, Issuance of new shares that are senior to or on par with Series A, Incur debt above \$X, Create a non-wholly owned subsidiary, Change the size of the Board of Directors, etc.
- Anti-dilution – Price protection in the event Company sells shares for less \$/share at its next financing round
 - Weighted Average OR Full Ratchet OR None
- Optional Conversion
- Limits on Mandatory Protection (discussed later)

- Weighted Average Conversion – Market provision

$$CP_2 = CP_1 \times (A+B) / (A+C)$$

- CP_2 = Series A Conversion Price in effect immediately after new issue
 CP_1 = Series A Conversion Price in effect immediately prior to new issue
 A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)
 B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP_1
 C = Number of shares of stock issued in the subject transaction

*What *fundamental* protections does the Company want?*

- Exclusions to Anti-Dilution provision
 - Stock issued pursuant to an Equity Incentive Plan approved by the Board
 - Stock or warrants issued in connection with equipment leasing or commercial borrowing
- Mandatory Conversion on Qualified Public Offering
- Pay-to-play
 - If “Major Investors” don’t invest in down-rounds, then they lose Anti-Dilution rights
 - Not often used as it is very Company friendly

Central investment document that includes all terms for the investment to be made.

- Representations and Warranties
- CFIUS Filing
- Conditions to Closing
 - Satisfactory legal and financial due diligence
 - Compliance with federal and state securities laws
 - Filing of Certificate of Incorporation
 - Entry into agreements such as those referenced in sample term sheet and Founder Stock Repurchase Agreement, Employment Agreement, etc.
- Expenses
 - Company typically agrees to pay a fixed amount of lead investors expenses

*What *contractual* protections do Investors want to protect the value of their investment?*

- Registration Rights
 - Demand Registration – After [3-5] years after investment, or [6] months after IPO, Investors can cause the Company to register their shares to sell publicly.
 - Can use this 1-2 times only
 - **When negotiating the term sheet it is important to know when the Investor needs to get their money out of your company*
 - Form S-3 Registration – Short form registration statement used after Company has been public more than 1 year.
 - Request 1-2 x per year
 - Less expensive for Company
 - Piggyback Registration – Investor can register and sell shares at the same time as the Company
 - Lock-up agreement – Company protection + will be required by underwriters
 - When does this provision terminate?

- Management Rights Letter
- Information Rights
 - Annual, Quarterly and Monthly financial statements, copy of budget, copy of cap table
 - Don't over-commit to when the Company can deliver information
 - Exclude smaller investors AND competitors
- Anti-Dilution - Right to Invest in Future Financings
- Matters Requiring Investor Director Approval
 - Make any loans to other entities / persons
 - Incur indebtedness in excess of \$_____ or guarantee indebtedness of others
 - Enter into a related party transaction
 - Hire, fire or change pay of executive officers
 - Change business of the Company
 - Sell or license IP (other than ordinary course)
 - Enter into material agreement involving payment in excess of \$_____

- Require non-competition / non-solicitation agreements with founders and key employees*
- Require non-disclosure and invention assignment agreements with all founders, employees, consultants
- Board Matters
 - Require the board to meet at specified frequency
 - Require D&O Insurance and / or Indemnification Agreements with Series A Director
- Employee Stock Options
 - Set standard vesting criteria
 - Set size of option pool
- Key Person Insurance

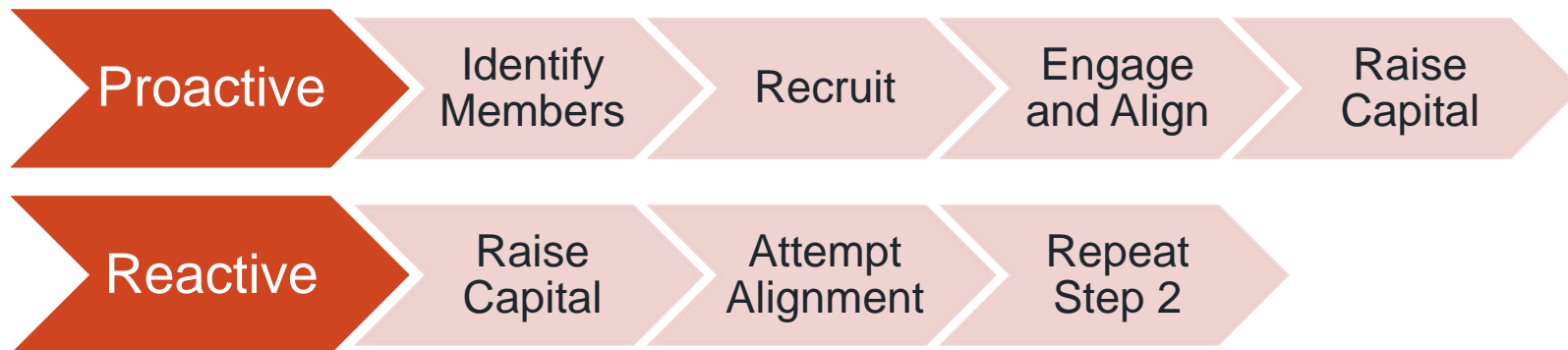
How to prevent (or make it very hard) for a Founder to sell his stock without an Investor being consulted first.

- Right of First (and Second) Refusal (ROFR)
 - If a Founder decides to sell his/her stock to a third-party, then
 - the Company has a first option to buy his/her stock at the offered price;
 - if the Company passes, the Investors have a second option to buy his/her stock
- Co-Sale
 - If neither the Company nor the Investor buy in the ROFR stage, then the Founder can sell to a third-party if the Investors can sell their pro-rata portion too

- Board Composition
 - Series A Director
 - Common Stock Directors (includes CEO)
 - Independent Directors
- Drag Along
 - Major Investors and Founders will agree to a Sale of the Company if X% of Preferred Shares approve it

Board Composition Vignette

- Plan your Board before you look for investment



Board Depth Chart

	Executive Function		Industry		Finance		Revenue		Board Experience
	Leadership	Management	Operations	Technology	Investor Relations	Accounting	Acquisition	Retention	
Board Member 1									
Board Member 2									
Board Member 3									
Board Member 4									

- Founders' Stock Vesting
 - Investors often impose buyback rights on stock held by Founders that is not already subject to vesting
- No Shop – Binding Provision
 - As an incentive for the Lead Investor to invest their time and money into a due diligence process with the Company, they ask for the Company to stop looking for investors of several weeks
- Confidentiality – Binding Provision
 - The Term Sheet is Confidential
- Expiration Date
 - If not accepted by set date, the Term Sheet expires
- Governing Law
 - Typically state that the Company is located in, Investor is located in or Delaware
 - Beware – The term sheet is non-binding, but Delaware courts have found that the requirement to negotiate in “good-faith” is binding regardless of term sheet language

Extras



- Asset Approach
- Income Approach
- Market Approach
- Rules of Thumb



Valuation Methodologies

- Adjusted net asset method

Basic Steps

- Adjust assets to fair market value
- Adjust liabilities to fair market value

Pros

- Provides “floor value” of the company
- Relatively simple analysis

Cons

- Often not indicative of value for healthy businesses
- May be necessary to obtain fixed asset and real estate appraisals



Valuation Methodologies

- Discounted cash flow method
- Capitalization of cash flow method
- Capitalization of earnings / Discounted future earnings

Basic Steps

- Determine benefit stream and make normalizing adjustments as appropriate
- Determine cash flow adjustments
- Determine discount/capitalization rate
- Discount / capitalize cash flows

Pros

- Provides most “company-specific” value
- Can appropriately incorporate projected growth of the business

Cons

- Most involved of the valuation analyses
- May be disagreements over likelihood of meeting projections



Valuation Methodologies

- Guideline transaction method
- Guideline public company method

Basic Steps

- Determine benefit stream and make normalizing adjustments as appropriate
- Find comparable transactions/guideline public companies
- Calculate valuation multiples and apply to subject company
- Make adjustments as necessary to arrive at equity value (if necessary)



Pros

- Incorporates market conditions and prices paid in recent relative transactions
- Easy to explain and apply

Cons

- Can be misleading if debt not appropriately considered
 - EBITDA multiples typically result in an Enterprise Value, not an Equity Value
- In certain industries, there may be a lack of comparable transactions or public companies



Valuation Methodologies

- Rule of thumb

Basic Steps

- Identify rule of thumb valuation metrics
- Apply rule of thumb to the subject company

Pros

- Simple application

Cons

- Can result in misleading values
- Often lacks support
- Not permitted to be used as a sole valuation method by most valuation standards



■ Control Discounts / Premiums

- Two options
 - Model in cash flows
 - Discreet discount / premium

■ How Are Adjustments Supported?

- Mergerstat Control Premium Study
 - Closed-end mutual fund data (for investment holding companies)



Remember that the magnitude of control and/or marketability discounts applied in any valuation analysis is heavily dependent on the facts and circumstances of the engagement

- **Marketability Discounts**
 - Controlling ownership interest
 - Non-controlling ownership interest
- **How Are Adjustments Supported?**
 - Restricted stock studies
 - Pre-IPO studies
 - FMV Opinions study
- **Option-based models**
- **Qualitative analysis (e.g. Mandelbaum factors)**



Remember that the magnitude of control and/or marketability discounts applied in any valuation analysis is heavily dependent on the facts and circumstances of the engagement

What is unique about early-stage companies?

- Little to no revenue
- Often operate at a significant loss
- Little to no tangible assets
- Limited applicability of traditional valuation methods
- Value is even more subjective than for an established company



“... a dollar and a dream.” – The Notorious B.I.G.