

Ready to Meet That First Real Investor?

By Mark W. Manning

You've been working on the idea for months or even years. Maybe you've found one or two people to work on it with you. And you've definitely been spending your own money to fund it, more than you'd hoped and probably some from "friends and family", too. The good news is your idea is now embodied in a full-fledged business plan, demonstration model or even a product. You're ready to pitch that first real investor. Or are you?

There is no shortage of war stories from founders of start-up companies about how hard it is to find that first check. It's hard to get in front of investors. But the bigger challenge is to get the thumbs up. While there are many subjective factors in an investor's decision-making process beyond your control, there are certain steps you can take which will maximize your chances of success.

Focus and Focus Again

There is a general consensus that investors weigh three aspects of a business plan most heavily: (1) the product or service presented, (2) its potential market and (3) the team. At its earliest stages, unless you've done this before or you've landed a recognized advisor, your business plan should focus almost exclusively on the first two. Within those areas, you should focus even further.

The discussion of the product and service should be a clear, precise explanation of what it will do, exactly where in the developmental process it is today, how long it will take to complete its development and how much that will cost. The history of the development, unless crucial to understanding what the product or service does, usually will not interest the investor. The investor is coming in now and wants to know how much capital you need to spend, when revenue will be earned and when the investment will be returned. Period. If your product or service could potentially perform more than one function

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or break into more than one market, pick just one as your focus. Mention the others, but stress that function for which, or the market in which, you are most likely to achieve penetration and establish a toehold. An investor telling you that you need to change or expand your focus is a good thing, indicating a level of interest beyond that given to the majority of start-ups.

The potential market for your product or service is almost always the most difficult area to address. Fortunately, the Internet now provides extraordinary amounts of information. You need both to find the right information and to use it properly. Collect and analyze the market data that is most appropriate to your company. If there is no perfect fit, extrapolate data from those markets which are closest. Narrow the chosen market down as much as possible to fit the exact demographics of your target buyers or users. While this may sound counter-intuitive, vast generalizations regarding an overly-broad market will make the investor feel that you haven't done your homework. Market analysis is a highly specialized field. Professional advice in this area, if available and affordable, is extremely helpful. If, despite your best efforts, you feel the market section of your business plan is weak, be honest with the investor that this is an area that needs to be better addressed. Such candor builds confidence in the investor's mind and establishes your credibility as a leader who will be forthcoming about the strengths and weaknesses of the company.

Pick a Brain or Two

Now is the time to build relationships with a lawyer, an accountant and perhaps a business consultant. Seek out

forward-looking, entrepreneurial professionals experienced in assisting emerging companies, who often can provide reduced or deferred fee arrangements, at least initially. Get referrals for service providers like these from colleagues, business associates or trade organizations. Stress the potential for a long-term association and that you are actively looking for capital. Many will offer a quick critique of your business plan. If you have already incorporated, ask a lawyer to take a look at your documentation. If you've involved others in your venture and you haven't formalized those relationships, ask about agreements relating to confidentiality, invention-assignment, stock options and buy-backs. If you've previously received funds from any other source, ask for help in creating an adequate level of debt or equity documentation to reflect this. Ask an accountant to help you create a simple pro forma balance sheet and even to assist you in creating a highly-detailed "use of proceeds" for the investor's review. If any of these is not in place when you meet with an investor, know what's missing and tell the investor. Again, this will help create confidence in the investor's mind that, while you are appropriately focused on product development, you know there are other things to be done when you have the resources.

Crafting a highly focused business plan which incorporates at least some input from the right professionals will increase your chances of success with investors. ■

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Employee Equity Participation: A Menu

By Howard D. Medwed

Employee equity participation programs are arrangements which provide employees with interests in profits, growth and/or governance (and perhaps more). Before deciding what kind of equity participation program to establish, an employer should identify its goals and its employees' goals. The tax and business consequences of each equity program must be evaluated to seek the greatest benefit and lowest cost to both employer and employee.

Employee equity participation serves many goals: performance incentive, orderly generational ownership transition, retirement funding, employee retention, non-monetary compensation and tax benefit. At the same time, a number of contradictions arise. Employers want a tax deduction, but will not be as eager to charge earnings. Employers may want to limit employees' governance rights and be reluctant to share financial information. Employers will not want to have ex-employee shareholders and be reluctant to pay out non-deductible dollars to their ex-employees to buy back their shares. Employees do not like taxes on a paper interest, and employers do not like funding taxes. These conflicts must be addressed.

The menu follows in brief:

Transfer of an unrestricted interest – Simplest program. Employer awards shares to employee. Employee has shareholder rights and taxable income equal to the value of the shares. Employer has withholding obligation and tax deduction. Problems range from tax reporting issues to burden of ex-employee (sometimes dissident) shareholders. These factors deter many from this program.

Transfer of restricted interests – Same as above except that the transfer is of an interest which is subject to a restriction which creates a risk of forfeiture (e.g. requirement that employee retransfer stock to employer if employment is terminated at any time before it vests). Scheme has the effect of treating transfer as occurring when the restriction lapses. Since shares which have little value early on can end up as winners, an election under Internal Revenue Code §83(b) to treat the shares as vested upon issuance may be worth-

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while. Although the election requires a fast decision and has downsides if there are future losses or an IRS valuation challenge, it is often a lottery ticket with little cost.

Sale at fair market value – Good solution for many. If shares have little current value, they can be restricted, and an §83(b) election can be made giving everyone what they want. A bargain sale is often less advantageous since the employee is taxed on the difference between value of stock and price, and employers must withhold the tax.

Employee Stock Ownership Plan (ESOP) – Qualified retirement plan which invests in employer stock. A number of goodies in tax law to encourage employee ownership through ESOPs, but not popular because of its broad untargeted benefits and cost of installation, maintenance and shareholder redemptions.

Incentive Stock Options (ISO) – Extremely popular over time, but currently out of fashion. Options must be issued under a plan meeting statutory requirements with a strike price that represents current fair market value at date of grant. Other rules limit both the amount of stock and term of option. Employee has no regular income upon exercise, alternative minimum taxable income on bargain element at date of exercise and, if he holds the stock long enough, capital gain treatment on sale. If employee sells within a short period after exercise (resulting in ordinary

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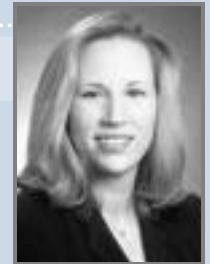
By Christina M. Murray

For the past quarter century, Massachusetts courts have upheld the constitutionality of a zoning bylaw if such bylaw bears a rational relation to a legitimate zoning purpose. Accordingly, many Massachusetts cities and towns have amended their zoning bylaws to restrict the rate of development occurring within their boundaries on an indefinite basis, asserting that the municipality's restricted rate of growth preserves the general character and welfare of the municipality. The Supreme Judicial Court, however, recently qualified this principle and held that, absent unusual circumstances, restrictions of unlimited duration on a municipality's rate of development are in derogation of the general welfare of a municipality and, therefore, unconstitutional.

The Court's recent decision in *Zuckerman v. Town of Hadley* will likely have statewide implications on the development restrictions adopted by many Massachusetts municipalities. The reasoning set forth by the Court in *Zuckerman* will likely encourage developers in other towns to challenge the development restrictions in their municipalities. While municipi-

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palities with similar bylaws will move to amend their bylaws in an attempt to more effectively preserve the character of their towns, quick-thinking developers may be able to take advantage of the opportunity the *Zuckerman* decision currently affords them. In adopting new bylaws, towns must recognize that the test of whether a bylaw restricting development bears a rational relation to a legitimate purpose has been strengthened. As the Court stated:

Where classic zoning bylaws keep the pig out of the parlor, rate of development bylaws tell the farmer how many new pigs may be in the barnyard each year. In their intent and in their effect, rate of development bylaws reallocate population growth from one town to another, and impose on other communities the increased burdens that one community seeks to avoid. Through zoning bylaws, a town

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Employer Policy Changes: Notice by Email or Ink

By Paul R. Mastrocola

An employer sends a company-wide email notifying employees about a new policy mandating arbitration of employment disputes. Later, an employee files a lawsuit in Court claiming that he was wrongfully terminated by the company because of a disability. The Court denies the employer's request that the former employee should be required to arbitrate his claim according to the new policy, and allows the lawsuit to proceed in Court.

On June 3, 2004, the Federal District Court in Massachusetts decided *Campbell v. General Dynamics, et. al.*, holding that a mass email message announcing a change in dispute resolution policy, without more, fails to meet the minimal level of notice required. In this case, the Court placed an added burden on the employer to expressly, clearly and unmistakably notify employees because the policy required employees to relinquish their rights to assert civil rights claims in Court. In these circumstances, employers are required to give employees "actual notice" in order to implement a mandatory arbitration agreement.

The Court observed that the employer did nothing more than just send the email, which it held was plainly insufficient for such an important policy change. It was not enough for the employer to demonstrate that the employee opened the email. It did not show that the employee read the email. Even email technology allowed the company to do better. For example, the email subject-header did not indicate that the message was of critical importance. The employer did not require the employee

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to send a return email stating that he read the email, or more importantly that he read the new policy and understood its implications. The employer did not require the employee to note "I accept" in a return email. Nor did it use the traditional methods of assuring notice such as holding a meeting announcing the dispute resolution policy with a sign-in sheet to monitor attendance.

This case should not be interpreted to mean that email notification of changes in employment policies is never appropriate. Email notification may

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may allow itself breathing room to plan for the channeling of normal growth; it may not turn that breathing room into a choke hold against further growth.

Attorneys at Burns & Levinson LLP have significant experience handling these issues for developers and municipalities alike. Please contact your attorney at Burns & Levinson LLP for further information on this new development. ■■

very well be sufficient for certain matters. For issues as significant as mandatory arbitration of employment discrimination claims, however, the employer must conduct email notifications carefully and properly for the policy to be enforceable. ■■

What's New

News

New Look: As you can see, we've updated the look of our newsletter and logo. We hope you like the changes that we've made.

David P. Rosenblatt [Managing Partner] was named Chairman of the Law Firm Alliance (LFA). The LFA is a national law firm referral network for mid-sized law firms (www.lawfirmalliance.com). [October 2004]

Michael J. Meagher [Partner] was appointed Chairman of the Alliance for the Commonwealth. The Alliance is the international trade arm of the Associated Industries of Massachusetts. [October 2004]

Renee Inomata [Partner] and **Mark F. Murphy** [Associate] were appointed as members of the *Boston Bar Journal's* Board of Editors for a three year term. [September 2004]

David P. Rosenblatt [Managing Partner] received the 2004 Judge Learned Hand Award from the American Jewish Committee. [June 2004]

Lisa Madeleine Cukier [Associate] was elected President of the Massachusetts Family & Probate Inn of Court. **Brian D. Bixby** [Partner] was elected Assistant Treasurer. [May 2004]

New attorneys: **David M. Amidon** [Partner, Corporate & Securities Groups], **Francine Gardikas** [Associate,

Divorce & Family Law Group], **Lauren E. Kohl** [Associate, Trusts & Estates Group], **Michael D. MacClary** [Associate, Real Estate Group] and **Kimberly B. Whitehead** [Associate, Intellectual Property Group].

Events

The Labor, Employment & Employee Benefits Group exhibits at the Northeast Human Resource Association's 2004 HR Invention Convention (www.nehra.com). [October 20 - October 22, 2004]

B&L Employment Solutions Workshop: Paving a Path to the Door: Avoiding Liability in Employment Terminations, *A Workshop for In-House Counsel* [September 29, 2004]

Recent Articles and Publications

The Changing Face of European VC Investing in the U.S. by Samuel M. Shafner [*CapitalVenue Newsletter*, Volume 12, Edition 25, October 4-8, 2004]

Time to Update Your Cobra Notices [*B&L Employment Solutions Update*, July 2004]

The New 8-K Disclosure Rules Are Far-Reaching by Andrew J. Merken [*New England In-House*, July 2004, pg. 7 and 34]

Please visit us at our web site (www.burnslev.com) to view more articles, updates, events and news. ■■

Burns & Levinson LLP is a leading full-service law firm. For over 40 years we have served a diverse group of individuals and corporations in all industries. The firm operates with an entrepreneurial spirit, like many of our clients, and uses a multi-disciplinary approach to achieve our clients' goals.

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Term Sheets: Proposal or Binding Contract?

By Lawrence P. Murray

In putting pen to paper, parties to negotiations typically take great pains to ensure that the words accurately reflect the business terms of the proposed deal. What may be overlooked, however, is the legal effect given to those terms even when one party to the negotiation does not believe that a binding contract was created. The recent case of *One to One Interactive, LLC (OTO), et al. v. Landrith*, makes it clear that if the parties fail to plainly state their intent as to the binding nature of negotiated documents, courts will do it for them, perhaps with unintended consequences.

OTO needed its members' consent, including Landrith's, to secure a third party investment. Before he would give such consent, Landrith insisted that OTO provide him with more favorable share redemption terms than those provided to OTO's members in the existing LLC operating agreement. In response, OTO sent Landrith a term sheet with a cover letter stating that formal documents would be drafted by the attorneys to be executed later. Landrith signed the term sheet and gave his approval to the investment deal. OTO prepared a more formal redemption agreement, echoing the

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term sheet, that was never delivered to Landrith. After Landrith's departure from the company, OTO made some payments under the term sheet, but then reneged.

OTO argued to the Court that the term sheet was only a proposal. The Court disagreed, finding that the term sheet transformed into a binding agreement because OTO knew that Landrith wanted to negotiate better redemption terms before he approved the investment deal, the parties signed the term sheet and OTO accepted Landrith's approval of the investment deal.

How could OTO have preserved its position that the parties were still negotiating? OTO should have plainly stated that the term sheet was qualified, that the parties intended to draft and execute a more detailed agreement, and that they intended to be bound only by such later agreement and not by the term sheet. Further, OTO should not have paid Landrith according to the term sheet, which caused the Court to disregard OTO's contention that it did not intend to be bound by that document. ☐

Focus

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income on the gain), he will have no alternative minimum taxable income (and no tax advantage).

Non-Statutory Options (NSO) – *Second simplest game in town.* No restrictions on number of shares, strike prices, or term. Like ISOs, NSOs result in no income at grant, but trigger ordinary income on bargain element at date of exercise unless the shares are restricted. At exercise the tax treatment is the same as other bargain purchases.

Phantom stock/profit pool arrangements – *Ideal for employers who want to limit their generosity to employees - gives a*

share of income and avoids giving property or governance rights. These are usually deferred compensation plans. There is a risk that employees will have constructive receipt prior to actual receipt. Properly structured and administered, employees will have ordinary income (and the employer a deduction) only when, as and if (and in the amount) received (or paid).

Profits interests – *Useful in partnerships and LLCs - especially in high tech or professional service areas.* A profits interest is an interest in the future income and appreciation of the employer from date of grant. The employee has no right to

receive anything if entity were liquidated on date of grant, and the interest has no current value, but great potential. Profits interests are becoming increasingly popular.

This menu is only a summary of some of the principal equity participation plans. It does not describe all consequences of any arrangement or describe all of the employee participation arrangements. It focuses on major tax issues. Business considerations, securities laws and other considerations may be more important. There is no one single equity participation arrangement which is best for everyone. ☐