

Angel financing could do with a little streamlining

Investments by angel groups have become too complicated. As groups get more aggressive in pursuing profits and seek more protection against downside risk, their deals have become as complex as venture capital deals.

This complexity costs time and money, reducing the benefit to both investors and companies. By streamlining the transaction structure, angel groups could simplify negotiations, shorten the time it takes to do a deal, reduce transaction costs, put more money to work building new companies and ultimately improve their own returns.

In the good old days, angels worked alone. They were wealthy individuals who funded the early stages of a company's development. Deals were typically simple.

Over time, individual angels began to join forces to evaluate companies and invest in groups. Members of The Breakfast Club, Common Angels, Hub Angels, Launchpad and others used their collective networks to identify potential investments, shared knowledge to analyze a company's strengths and pooled resources to invest together.

Angel group investments began to differ from investments by individual angels. Larger amounts of money were involved. Pre-investment assessment of the target companies became more thorough. To enhance investment upside and protect against downside risk, transaction terms became more stringent, borrowing more and more provisions from standard venture capital deals.

The number of angel groups has grown substantially. There are now dozens of them in the Northeast alone. These groups have become increasingly sophisticated. Angel groups frequently



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share information. Groups now syndicate deals, spreading the risk by sharing attractive investments.

At the same time, angel group deals have become as complex as venture capital deals. Today, angel groups typically purchase convertible, redeemable preferred stock with an accruing dividend, not common stock. The investments usually include a panoply of control and protective provisions, including registration rights, board seats, the ability to block certain actions of the company, redemption rights, rights of first refusal and co-sale rights. All these bells and whistles drag out negotiations, sometimes for months. They also raise transaction costs significantly.

Continued complexity in angel investments, however, is not inevitable. Angel groups should keep those parts of the current deal structure that are likely to have financial benefits and jettison provisions designed to protect against one-in-a-thousand contingencies. For example, they should continue to use a convertible preferred stock, with an accruing dividend and anti-dilution protection. But angel groups could simplify or delete a number of provisions of the standard transaction without substantially increasing their risks or decreasing their profits.

For example, the standard angel deal contains extensive provisions concerning the registration of investor shares

once the company goes public. These "registration rights" are of nominal value, especially to an investor in an early stage company. Investors would not suffer any noticeable loss if they replaced the 15 page Registration Rights Agreement with a simple statement precluding the company from giving registration rights to any person without the angel group's consent.

"Redemption rights" let angels force the company to buy back their shares after a fixed number of years if the company hasn't been sold or gone public. These provisions are standard in venture capital deals but are almost never used. Angels could delete them and never notice they were gone.

The right to elect a director is important, and angel groups usually do (and should) insist on a voice at the board. This can be accomplished with a short provision in the corporate charter. Determining the composition of the entire board isn't necessary if the founders still control the board.

Angel investors typically demand rights to acquire any shares being sold by common stockholders. Instead of the standard document spelling out the mechanics of share transfers and allocations (frequently a 12-page Right of First Refusal and Co-sale Agreement), angels should consider accepting a short covenant under which the common stockholders agree not to sell their shares without consent of the angels.

Angels expect efficiency and innovation from the companies in which they invest. They should also strive to become better investors by structuring efficient investment deals.

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