CORPORATE MATTERS:

ANGEL INVESTING, AN INTRODUCTION

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Bette Davis once said that growing old is not for sissies. If she were she alive today, she would no doubt be an accredited investor and may well add angel investing to the potentially long list of activities not for sissies.

Typically, angel investors provide seed capital to start-up companies or entrepreneurs. When an individual or newly formed closely-held entity seeks financing for a new venture, the most common sources of financing are individuals who have a preexisting relationship with the founders of the venture. With every I.P.O. of a former start-up and the corresponding stories of amazing returns on investment for the few initial investors, angel investing activity, as a whole, and the number of people seeking out such investments has steadily increased over the last decade. The Center for Venture Research at the University of New Hampshire found that the number of active angel investors in 2012 was 268,160. A decade earlier, that number had been approximately 200,000. The dollar amount invested over the same period grew to $22.9 billion from $15.7 billion. There is potential for the numbers to grow further: The Angel Capital Association estimates that there are approximately four million potential accredited investors (persons with an individual or joint net worth with a spouse that exceeds $1 million - not counting the primary residence) in the United States who might be interested in startup and early stage companies.

This increase is despite the fact that approximately 80% of startups fail. Many investments made by angel investors end up worthless or sit for long periods in inert companies that buyers have little interest in.

When initially investigating a potential investment, realize that the founders, owners and managers are usually the same persons. This group should have a common goal that is shared by you, in terms of your investment outlook. The goals of the founders may quickly determine whether it is the type of venture you want to invest it. For example, what is the exit strategy of the founders – are they planning an I.P.O. or are they working towards selling the company in five years or when a certain value is reached? Many legal, financial, and business decisions would be made in a certain way if the goal were to go public in three years as compared with staying private indefinitely.[60] Also realize that the time frame in this type of investment is long. According to Dow Jones VentureSource, venture capital firms,

[60] Lee R. Petillon & Robert Joe Hull, *Representing Start Up Companies* (1992).

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which usually invest in start-ups several years after angel investors, wait a median 7.35 years for a start-up to achieve liquidity through an I.P.O. and a median 5.21 years for an acquisition.

If one is considering becoming an angel investor, the due diligence process should be taken very seriously. An article by Martin C. Zwilling highlights some important considerations.[61] He refers to the confusion in the entrepreneur and investor community between viability and fundability when outlining reasons why an investor may decline to invest or hold off on investing until the company has finished a particular product or signed up a few customers. He states that non-viable businesses should not be funded, which, as he points out, is obvious, but many viable businesses are also not fundable. The reasons he gives form a useful checklist to consider when thinking of making an investment in a startup company.

1. **Business plan.** If the founders have not been able to come up with a good business plan, no matter how good the idea, they have obviously not thought through how to make the business work. Founders who start a business without a good written plan almost always fail.

2. **Experience of the team.** If the founders are not experienced in building a business, an investor may want to hold off until they can partner with someone with more expertise.

3. **Type of business.** Certain sectors have higher failure rates than others (*e.g.*, food service, retail).

4. **Opportunity for growth.** Is there a large and growing market for the product?

5. **Competitive advantage.** Can the idea be protected from others in the same business sector?

As diversification is key in angel investing and many investors cannot sufficiently diversify their portfolio alone, there has been a proliferation, over the last decade or so, of angel investing groups. The Angel Capital Association estimates that there are today approximately 300 formal and informal angel groups in the United States and Canada with about 15,000 individual members, as opposed to 50 such groups in the late nineties. The growth has been due to several factors, including the ability of a group, however informal, to generate better deals than an individual, the complexity of seed capital investing, the growth and attractiveness of venture capital investing, and the large and growing number of self-made high net worth individuals looking to mentor others.

Always have your legal adviser review any documentation surrounding an early stage investment, even if you have a preexisting relationship with the founders. Items such as restrictions on founders selling stock may be missing from standardized paperwork, so it is always advisable to have a seasoned legal advisor review the deal.

[61] See *supra* note 1.