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PROTECTING YOUR POSSIBILITIES PODCAST WITH LUKE FEDLAM

Episode 59: Investing in a business? Here's what you need to know! | Nov. 17, 2021

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Luke: I'm sports attorney Luke Fedlam, and welcome to the Protecting Your Possibilities podcast. Each conversation we focus on sharing information and having conversations around how athletes can best educate and protect themselves or their life outside of their sports.

Thank you so much for tuning in to the Protecting Your Possibilities podcast. I'm your host, Luke Fedlam. And we are here, excited to have another episode. And this is one that I get asked about a lot. I've had conversations with athletes with teams and front office personnel, player, engagement staff at pro teams, parents, and so many others around this topic of athletes and deals. And so we're going to get into athletes and deals, investment, you know, private business investments and business deals. And I have a great resource for this conversation. A friend and colleague Ryan Steele. Ryan, how are you?

Ryan: I'm good. Thank you for having me.

Luke: Absolutely. So Ryan, is one of my colleagues here, Porter Wright, he works in our corporate and securities department, and he is my go to, when I'm working with athlete clients, and we have deals that are presented, he is one of the one of the folks that I lean on. In doing the analysis, the legal analysis for the deals that we have. And so I thought it would be great to have a conversation with Ryan, just broadly, because I think a lot of times people don't necessarily understand kind of how deals work, what to look out for, and how to ultimately protect yourself. And I mean, hey, that is our podcast, Protecting Your Possibilities. So we want to make sure that you're getting some good information here, to be able to put it into effect and ultimately, protect yourself.

So when we're talking about these deals, we're typically kind of talking about situations where someone wants you or wants an athlete to invest in a business opportunity, right. And so, you know, that could take on many different forms, we're going to get into that, and what that may look like. But as you as you listen to this conversation, kind of think of it in the sense of someone wanting to get an athlete wanting to get an athlete to invest their money into this business opportunity. So, Ryan, when that happens, what are some of the documents right? What are some of the things that either the athlete or the parents of the athlete or the financial advisors, what are some documents that should be requested by that company from the company, that is that the athlete is investing in?

Ryan: Sure, and we may even get to this in a bit more detail later. But it really depends on the life stage of the company. At a bare minimum, we want to see a term sheet that has the deal terms. As an entry level point, you need to know what you're getting. And the term sheets usually given a decent amount of background information on the company. And that's a good threshold entry into okay, what is this actual investment round entail? And then from there, you know, if it's a go at that point, the numbers look good, we've got a decent information, kind of, we pass that initial smell test, and then we'll start asking for more baseline governance documents, underlying agreements with the founders to get a sense for how good a shape this company is.

Luke: Okay, so with the term sheet, like, basically saying what the, what the standard deal terms are, what should you expect to see on that? Right? What, what typically, you're gonna see in like, a basic term sheet, right?

Ryan: Well, I want to know what I'm buying, and how much of it do I get. And so if you're buying equity, the term sheet should say, we are raising up to a million dollars, and that is going to account for 10% of our company. So great. So I could do the math, if I know I'm willing to put in $100,000, I know that gives me 1% of the company, if they sell the whole round out. And that's really important. You need to know what your money is getting you. And so one of the documents that you should see, even at the term sheet stage before asking for it is a cap table. We need to know who owns this company who owns what, what kind of ownership do they hand have? Because not all ownership is created equal? And those are the kind of things that we really started digging into at the beginning.

Luke: Yeah, so just to clarify that. So cap table is it really is like short for capitalization table, and it tells someone how a company is capitalized. So who the owners are, what percent do they own? What type of or class of ownership do they have? And that will then tell us what rights come with that. So knowing kind of on the front end, who the owners are, is something that you should, you know, you should have that you should have that cap table at the very beginning stages, as Ryan said, when you're even just thinking about the term sheet itself, right? So when we when we think about that, okay, we've got the term sheet, I know that I'm investing, you know, in this company, it's going to be you know, x 1000s of dollars that I'm going to be investing, then these are kind of the terms this is what I'll get out of it, etc. Then what? So let's say the term sheet looks great. We're feeling pretty good. And we start to get a capitalization table. Then what happens? What should What should we do next?

Ryan: So at that point, we should start looking at the documents we talked about earlier. So the underlying governance documents, do they have shareholders agreement and operating agreement kind of depends on what kind of entity they are. And then most importantly, after that is the actual investment documents themselves. If you're buying equity, there should be a subscription agreement, potentially a stock purchase agreement there. If you're going to be purchasing what's referred to as convertible debt, or just pure debt, there should be a promissory note and some other ancillary agreements. So we should get a full view of what's already in place, you know, what's happened from inception of the company to date, as well as what we are expected to sign as part of that investment round.

Luke: That's where, you know, that's where we get involved, oftentimes, where we'll say to our clients, Hey, these are the documents now that we need to request. And we do that, because now we want to be able to understand what are all the terms of the actual kind of deal that we're getting involved in? So what is it that you're getting into, so when we think about whether it's a shareholder agreement, operating agreement, you know, etc. It helps you to understand then what rights are you going to have? What protections might you have? What are some of the potential risks or red flags to you? So these are all documents, they're going to help shape the picture of what this investment is going to ultimately look like for you. Does that, would that be accurate?

Ryan: Yeah, absolutely. Because you see all kinds of things, you might think, Hey, I'm buying 10% of this company, that's going to give me 10%, of all of these rights, or all of the rights to the money. And that's not always the case, sometimes something would have happened beforehand, where well, the founders had actually granted themselves, you know, 10,000-to-1 voting rights, and a different class of stock, or your 10% only gets paid after for other classes of stock before you get paid. And so there's a lot of analysis that needs done to really get down to what you're actually buying. Because the term sheet by itself is not enough, it's a great entry point, it's a good go, no go point. But it really does take a deep dive into the agreements that are in place, as well as the deal documents, so that we can give you a better picture of what you're actually purchasing with your money.

Luke: Now, that's, it's so good. And I think it's so important, right? To understand what it is that you're actually buying. Because sometimes somebody may sell you by saying, Hey, I'm gonna give you know, 10,000 shares, or you give me this amount of money, I'm gonna give you this many shares in the company. But that doesn't really mean anything, if you don't have the broader picture, right? How many total shares are authorized? What rights come with this class of shares that I'm getting? Right? I mean, there are so many other things that come with what you're actually purchasing beyond what you've been sold on the front end?

Ryan: Absolutely. And sometimes we even find out that the board of directors or the officers may just be able to issue more shares at will or that there's a big pile of equity compensation shares, which are given to consultants that are going to dilute you down. So yeah, 10,000 shares without context means nothing, because especially in Delaware, where a lot of these companies are formed, you can pretty much authorize an unlimited number of shares.

Luke: Yeah. So let me ask you this, then. So, what about structure? So if you get to the point where it's like we've, you know, we've got the term sheet, we've got the capitalization table, we've gone through these documents, and we're saying, hey, these documents, you know, maybe we're making some edits and negotiating those terms. But what about the structure of the investment to the athlete like, and what I mean by that, in particular is, you know, I think that there are times where athletes, when I'm having conversations with athletes, it's like a deal is presented to them. And they feel like it's very much a binary decision, either, yes, I'm going to do it or no, I'm not going to do it. And oftentimes, they get sold on that business idea, and they want to do the deal. But the structure can change, right? I mean, how would that work? I mean, can you change the structure of a deal, kind of through negotiating? Or, you know, by having kind of a plan for maybe I don't want to do this as an equity deal? Maybe I want to do it as a loan, or what would that look like?

Ryan: So really depends on what your position is and what your leverage is in the deal. A lot of times you're coming in, and there's been what's referred to as a lead investor that has negotiated the deal term, sometimes it'll be a large venture capital firm. At that time, you don't really have a lot of say,

Luke: Yeah

Ryan: Iif they're the lead investor is coming in for 5 million and you're coming in for $50,000. That's a little bit more taker to leave it. But if this is truly a startup, and this is something that comes to you, and maybe it's an acquaintance and you're going to be the first money in or you're going to be the most money in, then absolutely I mean, it's your it's your deal at that point. So, you know, whatever the company comes to you with is not necessarily the end all be all you absolutely have a right to restructure it. negotiate the deal. Herms changed the deal entirely from debt to equity, or vice versa.

Luke: So if you're listening to this, you, you, you're getting a good sense of, you know, the excitement that I get whenever I work with Ryan, because he clearly knows what he's talking about, and is able to communicate it as well. But I think Ryan, you just hit on something that is so important to discuss, which is this idea of startups, especially when they come from acquaintances, friends, family, etc. So, here's the issue, right? The issue is that a lot of times you have a startup that is just trying to get going, they're not trying to spend a lot of money on legal fees to get, you know, investment documents drafted and things along those lines. You know, they may have a relationship with that athlete and say, Hey, we really want you to come, you know, be an investor. And the athletes probably going to be, you know, we either one of the first investors or one of the biggest investors. And so, because of that acquaintance or familiar relationship, they may say, Yeah, we don't really have the documents, you know, because we haven't spent the money on legal like, but you know, us, right, you can trust us. I mean, what do you, what do you say to that? I don't I say that, I'm gonna let you go first. What do you say to those kind of situations?

Ryan: Well, I never tried to be the one to say no to a business opportunity. But that is some of the riskiest money you can invest. And what makes it so risky? Well, you have, you have no operating history in place. You do not have the legal framework that would give you as much protections as you can. And so one of the big protections that we look for when advising investors is the intellectual property. Has the company taken all the steps necessary to secure its intellectual property rights? So if you hire a consultant, and let's say, you're a tech startup, and they're doing some coding work for you, and they have not executed an assignment of inventions agreement, they maybe don't own as much of their property that they think they owe. So at the beginning, we don't have a nice complete set of legal documentation. We really don't have any revenues, so valuing the company becomes much more difficult earlier you are. It's very risky money. So what we've seen in the marketplace, and there are venture capital firms that focus on startups, and do founding and seed round investments. Those documents are very founder friendly; they're often secured with liens on any assets. So you have a lot of leverage at that point. So you know, our advice to clients that are approached with these types of investments from acquaintances is, let's still be thoughtful with how we invest our money and not just take folks at their word, because even with the best of intentions, things go sideways, and we need to do everything we can do to protect your investment.

Luke: Yes, yes. I come outright just say, No, don't do this. I'm just kidding. I do. I do, though, say, you know, I always want to understand why an athlete wants to do a deal. And I think that it's important to understand the why. Is this is this because I'm looking for a financial return? Is this because I really am interested in the business and want to kind of, you know, grow with this business for my own development? Is this a an industry that I think is taking off? And I want to kind of be involved kind of in this, you know, this new technology or this new way of doing things? Or is it just, you know, hey, I want this deal to fulfill this part of my overall kind of asset allocation as I look at my overall kind of investment portfolio, if you will. But you know, I'll never forget, I had a client one time who asked about - this was a real estate development deal. And I'm not a real estate attorney, but I was going to turn the documents over to our real estate team. And I said, Yes, send me the documents for this development deal. And it was two pages long. And I'm like, Okay, well, we can't really do a real estate development deal on two pages, especially when we don't talk about who actually owns the land and all this other kind of stuff. But I asked the client, you know, why do you want to do this. And he had a number of reasons as to why. Around, he was transitioning out of playing professional sports, he knew the developer, he wanted to grow with the developer and learn and all this kind of stuff. So we ultimately did it as a debt deal, right, where he just loaned the money as opposed to doing it with equity. And it, you know, ended up you know, working out well for him. So I think understanding right, and to Ryan's point, you know, we it, we don't want to just say no to clients, sometimes we need to, based on the red flags that we see. But we always want to understand why and figure out if there's a way to still structure something that can protect the athlete and their investment. But that brings up a I think, an interesting point around red flags. So when you're looking at deals, and you're, you know, kind of doing your legal analysis on deal documents, deal terms, and the underlying kind of documents that we've discussed. What are some of the red flags, that really stick out to you that that many people don't either think about or don't know to look for

Ryan: Sure. So securities laws are very complex. And they're not common sense. And, you know, I've been practicing for 10 years, and I'm still learning them as I go. But they're meant to protect the investor. And a lot of companies don't realize that. And so what we look for is a company that does take very careful consideration, securities laws, make sure to give us all the information that we expect to see. Make sure to comply with all applicable state and federal securities laws. And if we don't see that, that's the first red flag, and that comes up at the term sheet stage. That comes up when we see the underlying governance documents. Have they engaged, sophisticated legal counsel to help establish the baseline? Because as the company continues to grow, that's when these cracks in the foundation really start to become a problem. When you're a young startup company and are maybe we don't have employment agreements are made, we don't have a good operating agreement, it doesn't really matter, right? When you are now making millions of dollars in revenue, and you're thinking about going public, a lot more eyes on you a lot more money at play, that stuff starts to make a big difference. So as you enter into the world of investment, you're kind of exiting that startup in the garage space, we need to see some good underlying documents. And we need to see that the investment documents are prepared thoughtfully. Because if they're not done right, there's what is referred to as a rescission claim by your investors. So an example of this is let's say, the company wants to raise a million dollars. And it's doing so under a securities law exemption that lets us sell to an unlimited number of folks. But we can't advertise, right? That's a very common one. But they've reached you an athlete through some means of general solicitation or advertising. Well, they have now blown their exemption. And anybody that invests in that round now can come back and claim and get their money back basically. And that's going to devalue your investment, even if you want to stay in it. Because now the company has to spend that money, plus legal fees, giving folks their money back that were unhappy, or were misled. So what seems like oh, well, we didn't do this right in the first place down the road, there's opportunists. There's bad actors that see an opportunity to come make some money, and will then you know, make a scene and get their money back, and it then hurts your investment significantly, and can sometimes be the end of a company. And we've seen that happen.

Luke: Wow, wow. Yeah, definitely things to look out for. And that's why, you know, in all of this, I think it's so important that, you know, anytime you're making an investment is, you know, in a private business or other type of business investment, you really want to make sure that you have legal counsel, reviewing the documents and doing the analysis for you to make sure just for those purposes, that that Ryan mentioned that you're protected.

So alright, we're about to wrap up here. But before we do one last kind of area to talk about, which I think is probably most important, that a lot of times people don't necessarily think about, which is - how do you actually get your money back? Alright, so you, you decided, hey, you know, I invested in this business, whatever, I put x 1000s of dollars into this business, man, it's doing really well. What does that mean? Like? How do I actually get paid? So with a loan, it's easy, right? I make a loan, I have an interest rate, I get paid back, you know, whether it's, you know, principal and interest or just, you know, interest only and then, you know, lump sum principle down the road. But when it comes to making an investment, especially an equity investment, how do I get paid?

Ryan: Yeah, and that's a good point, because it's, it's often not as immediate as you would expect it to be. And a lot of cases, not even at all. So with an equity investment, you're waiting for one of three things to happen. One, you're going to get paid dividends on your equity. And for a startup company and an early stage company, it doesn't really happen all that money is being reinvested in the growth of the company. So there's often not a lot of dollars to actually pay out to the shareholders in the early stages. The second is a public offering where you now you can sell your shares freely, because one thing to think about with an equity investment in a private company is you can't turn around and sell that equity. There's no public market for that, until the company takes the steps necessary to allow that. So if you're six months in, and you say, You know what, I kind of want my $100,000 back, you're stuck. There's no way to get it back. Until those shares are freely traded on an exchange somewhere, there's not much you can do about it. And a lot of companies don't go public. And if they do, it takes 5, 7, 10 years actually get to that point. The third way, the most common way is the company sells and has an exit either through bankruptcy and liquidation or through a sale of the asset or the equity to a larger competitor often or somebody else are going to grow into the space. And that's most common when you can expect to see some return on your capital but by then, it's really hard to forecast what that's going to look like there may have been three four subsequent rounds of financing since your investment they may have that needs to get paid first.

So it's hard to really gauge what your return is going to be, we can add certain provisions in there. And without going into too much detail what those are, because that would be a whole other podcast. So we can try to guarantee some rate of return. But really, you're kind of hidden, hoping for a home run. You know, venture capital firms that do this for a living, make their money on, you know, 10 to 20% of their investments, right? I mean, some of them just get through their money back. Some of them are losses, and then they live and die off the homeruns. Right, yeah, try to get, you know, 10, 20% depending on what market you're in. And so if you're just investing here and there, you kind of got to understand that there's maybe an 80% chance you're not going to get anything back and maybe most your money back. So the money doesn't come easy, and it doesn't come quickly. But if you do find the right investment, you can definitely see one of those homerun returns.

Luke: Awesome. Listen. Thank you, Ryan, so much for joining us today on the Protecting Your Possibilities podcast. Hopefully, you all, you know, got a lot out of this conversation. Clearly, Ryan knows what he's talking about doing great work in this space of protecting clients, when it comes to private investments. And I'll just say one last thing. As athletes, you always want to remember that people are going to target you to get you to invest in businesses and opportunities, because you are a celebrity; because you are an athlete. And they can use your name to go out and get other people to invest by saying, Oh, well, if so and so athlete is involved, you know, then that I want to be involved to I want to be a part of that. They must know something or, or what have you. So you always want to be mindful that you are doing your due diligence, your investigation or your analysis, not just on the opportunity itself, but also who's bringing that opportunity to you and for what purposes. So, again, Ryan, thanks, my dude, I really appreciate it.

Ryan: Thanks for having me.

Luke: Absolutely. Again, thanks for tuning into the Protecting Your Possibilities podcast. We are always looking for any feedback that you have ideas for content and topics to discuss. Continue to share the podcast with anyone in your circle. Give us five stars if you want to rate it somewhere and continue to just share the good word of the Protecting Your Possibilities podcast. I appreciate you for listening. Thank you all so much. Have a great day.