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- Committee Reports ... **CR**
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INFORMATION COLLECTED BY COMMITTEE FOR AND AGAINST PROPOSAL

- Appointments ... **Appt** (w/Record of Comm. Proceedings)
- Clearinghouse Rules ... **CRule** (w/Record of Comm. Proceedings)
- Hearing Records ... bills and resolutions (w/Record of Comm. Proceedings)
  (**ab** = Assembly Bill) (**ar** = Assembly Resolution) (**ajr** = Assembly Joint Resolution)
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ANGEL INVESTMENT GROUPS, NETWORKS, AND FUNDS:

A Guidebook to Developing the Right Angel Organization for Your Community

AUGUST [illegible] EDITION

SUSAN L. PRESTON

IN ASSOCIATION WITH

KAUFFMAN Foundation

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A Guidebook to Developing the Right Angel Organization for Your Community

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The author, Susan L. Preston, Esq., is an Entrepreneur-in-Residence of the Ewing Marion Kauffman Foundation. Ms. Preston has an extensive background in early-stage financing as an angel investor, founder of an angel organization, and counsel to numerous early-stage companies and investors.

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INTRODUCTION

From 1996 to 2003, the number of angel organizations[1] in the United States increased significantly from an estimated 10 to about 200 groups. This growth occurred because individual angel investors found many advantages to working together — better investment decisions, enhanced deal flow, the ability to combine their funds into larger equity investments, and group social attributes. Nearly all of these groups created their structure *de novo* having little or no guidance or best practices to follow. To meet the need for information, this Guidebook has been developed to help in the establishment of angel groups most appropriate for prospective member investors and related community. It is designed to provide practical suggestions, tools, and best practices in starting and operating an angel group.

Starting any type of group can be a daunting task. Establishing a successful angel group can be particularly difficult because angel groups are a recent phenomenon, and angel investors are notoriously private. To make matters more confusing, many different organizational models or structures have been successful. In addition, success is not necessarily measured by return on investment, since angels typically invest at an early stage, and returns may not be seen for several years. Instead, success may be measured by factors such as member retention, investment rate, accomplishment of goals, and member satisfaction.

Despite a seeming morass of variables and choices, there are basic factors, decision points, and questions that should help you determine the type of structure that best suits you, your member base, and community. This Guidebook is intended to take you through a decision-making process to determine the best structure for you, provide examples of organizational structures and functions, and give you a head start in establishing your angel group with some critical documents and guidelines.

One size does not fit all, however. So, after you have gone through the discussions, questions, and options outlined in this Guidebook and come to a conclusion for a particular step or factor, you may decide to choose a different model just because your membership has a greater comfort level with more or less structure at this point in your organizational development. Recognition and acceptance of the need for growth are important, and willingness to adjust your model, goals, and orientation will be important for your organization's long-term success.

You should be sure to consult qualified counsel regarding federal, state, and local rules and regulations that may govern your organization. Attorneys and accountants can be invaluable to any organization, and you should avail yourself of their knowledge and background to ensure the legality and economic value of your angel group.[2]

[1] Throughout this Guidebook, the terms "group" and "organization" are used interchangeably.

[2] This Guidebook is intended to enhance the reader's awareness of the variables and attributes of establishing and operating an angel organization and should not in any way be substituted for professional advice. One should retain appropriate regional counsel to ensure compliance with local, state, and federal laws.

BACKGROUND

Angel investors have proven themselves to be an integral part of the capital market, particularly for funding start-up companies and providing first-phase financing of businesses. The term "angel" originated in the early 1900s and referred to investors who made risky investments to support Broadway theatrical productions. Today, the term "angel" refers to high-net worth individuals, or "accredited investors," who typically invest in and support start-up companies in their early stages of growth.

DEFINITION: *The term **"accredited investor"** under the Securities Act of 1933, as amended, includes the following definitions with regard to individual investors: "Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000"; and "Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year." With regard to organizations, an accredited investor is: "Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000."*

In the financial world today, angel investors are a critical and essential part of a healthy economy, particularly for the establishment and growth of early-stage companies. Experts estimate that, on a cumulative basis, the level of investments made by angels over the last 30 years has been double that of investments made by venture capitalists.[3] The Center for Venture Research (the "CVR") at the Whittmore School of Business and Economics at the University of New Hampshire[4] estimates that angel investments for 2003 were approximately $18.1 billion in 42,000 deals, down from the historical — last 10 years — investment trend of approximately $30 billion per year in 50,000 ventures. This investment amount is comparable to venture capital funds, which, according to the National Venture Capital Association, invested $18.2 billion in 2003, with only 2% of those dollars in seed or early-stage investments.

In addition to the value provided by early funding, angel investors are typically experienced professionals who can offer wisdom and guidance to the entrepreneur and who have the patience to allow time for normal company maturation. With few exceptions, angels invest on a regional basis, being interested in personal relationships with companies and employees, as well as in giving back to their communities.

[3] According to statistics published by the National Venture Capital Association and the Center for Venture Research, University of New Hampshire.

[4] Sincerest thanks and appreciation to Dr. Jeffrey Sohl, Director of the Center for Venture Research, for permission to use selected results of the 2003 angel group survey.

Angel groups, which have more resources than individual angels, are playing a more crucial role in funding young companies, as well as in funding second-stage companies, leveraged buyouts, and spin-offs. Historically, the funding gap between investments made by friends and family and the point at which companies could realistically obtain financing from venture capitalists was between $500,000 and $2 million in invested capital. Individual angels could often meet these funding needs. However, with venture capitalists moving further up the funding chain by not investing as early in a company's development, a second funding gap has emerged between $2 million and $5 million.[5] Added to this problem of venture capitalists preferring larger deals is the definitive drop in venture capitalists funding seed or start-up stage companies. The following table and graphs demonstrate this trend in the last few years of significant decrease in venture capital funds both of numbers of investments and of total dollars invested.

DEFINITIONS: *The definition of these various stages of business development and corresponding financing can vary between publications and individuals. For purposes of this Guidebook, the following definitions for stages of financing will be utilized from* Pratt's Guidebook to Venture Capital Sources; *2001 Edition, Thomson Financial/Venture Economics:*

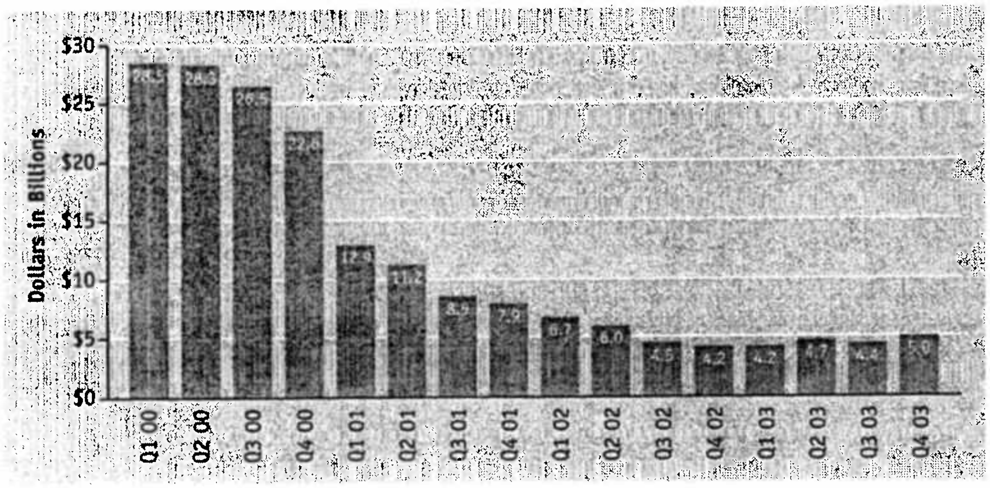
- *Seed financing "is a relatively small amount of capital provided to an inventor or entrepreneur to prove a concept and to qualify for start-up capital. This may involve product development and market research as well as building a management team and developing a business plan, if the initial steps are successful." (By this definition, pre-seed financing would denote financing to help articulate the concept.)*
- *Start-up financing "is provided to companies completing product development and initial marketing. Companies may be in the process of organizing, or they may already be in business for one year or less, but have not sold their product commercially. Usually such firms will have made market studies, assembled the key management, developed a business plan and are ready to do business."*
- *Early- or first-stage financing "is provided to companies that have expended their initial capital (often in developing and market testing a prototype) and require funds to initiate full-scale manufacturing and sales."*
- *Expansion financing is second and subsequent investment rounds typically financing company product and/or market expansion, or keeping the company financially healthy shortly before a liquidity event such as an initial public offering (IPO) or acquisition.*

[5] Jeffrey E. Sohl, "The Private Equity Market Gyrations: What Has Been Learned?" *Venture Capital: An International Journal of Entrepreneurial Finance*, Vol. 4, No. 4, 2002, pgs. 267-274.

TABLE 1
Equity Capital Sources for Entrepreneurs

STAGE	PRE-SEED	SEED/ START-UP		EARLY LATER
Source	Founders, Friends and Family	Individual Angels	**Funding Gaps:** 1. Between $500,000 and $2,000,000; 2. Between $2,000,000 and $5,000,000	Venture Funds
Investment	$25,000 to $100,000	$100,000 to $500,000		$2,000,000/ $5,000,000 and up

GRAPH 1[6]
National Venture Capital Investments, 2000 - 2003



The relatively new funding gaps of $500,000 to $2,000,000 and most recently also $2,000,000 to $5,000,000, combined with the fairly recent precipitous drop in overall venture funding, has created a domino effect of problems for early-stage companies, particularly for companies in late "start-up" or "first-stage financing" phases of critical growth and momentum. Angel groups can be a solution.

Few individual angels can accommodate the increased dollar needs of growing entrepreneurial companies, particularly in the $2,000,000 to $5,000,000 range, before venture capitalists are considering investments, and at a time of critical growth for a young company. But, by combining resources of individual investors, angel groups can be the proverbial white knights. Funding this second gap of $2,000,000 to $5,000,000 typically requires a co-investment strategy, and angel groups can be a potential solution through the combined funding resources of a group of individual angel investors. These groups also have the combined manpower for analysis of multiple or complex investment opportunities, further aiding in making these investments possible.

[6] Source: National Venture Capital Association

TABLE 2[7]
Venture Capital Funds, 1995 - 2003

YEAR	TOTAL (BILLIONS)	DEALS	PER DEAL (MILLIONS)
1995	$7.7	1,874	$4.1
1996	$11.5	2,612	$4.4
1997	$14.8	3,185	$4.6
1998	$21.3	3,695	$5.8
1999	$54.3	5,608	$9.7
2000	$105.9	8,082	$13.1
2001	$40.6	4,600	$8.8
2002	$21.4	3,035	$7.1
2003	$18.2	2,715	$6.7

TABLE 3[8]
VC Seed and Start-Up Financings, 1999 - 2003

YEAR	SEED & START-UP TOTAL	PERCENT OF TOTAL VC FUNDS	SEED & START-UP DEALS	PERCENT OF TOTAL VC DEALS
1999	$3.3 billion	6.1%	809	14.4%
2000	$3.0 billion	2.9%	672	8.3%
2001	$767.0 million	1.9%	251	5.4%
2002	$352.0 million	1.7%	155	5.1%
2003	$354.0 million	2.0%	166	6.1%

[7] Source: National Venture Capital Association
[8] Source: National Venture Capital Association

FUNDAMENTALS

At first glance, angel groups come in as many shapes, sizes, styles, and structures as flavors of jellybeans. But one factor does appear to be relatively constant: recent surveys of angel groups by the Center for Venture Research show that one of the primary criteria for membership is net worth or **accredited investor status of the group members**. Another constant and part of the definition that separates angel groups from other investment vehicles is the **active participation of angel group members in the investment of their own capital.** In contrast, venture capital funds, broker-dealers and investment bankers typically operate on a passive investor model — the individual is not actively involved in the investment decision-making process.

From this definition of active investment of one's own capital, an angel group is, then, a group of angel investors investing through a member-directed investment process. The actual investment direction process may vary considerably, but all members have input either through their individual decision to invest or as a member of the group to invest part of the group's fund. Angel organizations can be everything from an informal group of individuals who conduct cooperative due diligence to a group with paid management and committed investment funds.

Any successful angel group needs to address several issues:

Accredited Investors: Angel groups can self-select by numerous criteria, including industry focus, gender, or other variables. But as statistics support, substantially all of the group's members should be "accredited investors" (see previous definition). The words "should be" are purposely used because there are few regulations regardng the structure or membership criteria for angel organizations. These requirements come into play, however, at the time of investment. Companies typically refuse investors that do not qualify as "accredited investors," in large part because of regulatory infomation-disclosure and reporting requirements and the funding limitations imposed upon companies for acceptance of investments from non-accredited investors. Again, this does not mean that your members must be accredited investors, but entrepreneurs will have less incentive or interest in presenting to your angel organization or going through the arduous steps of due diligence with a group that has only a minimal percentage of accredited, and thus potential, investors.

The accredited investor status requirement also relates to deal flow for your angel group. If your organization is known for having active investors, high-quality potential investment deals are more likely to seek out your group for investment opportunity. In addition, accredited investors are often previously successful entrepreneurs, which is consistent with survey results showing that two other important criteria for membership are past investment experiences and member referrals of investable companies.

A Champion: A key factor in the success of an angel organization is an appropriate and active champion. One cannot over-emphasize the importance and necessity of an individual or small group of people to champion the establishment and instigation of your angel organization. Often, the desire of those forming the angel group will influence the structure of the ultimate organization. They will also likely be the source of other members with similar interests and confidence in your champion or founding group. Advisors are also extremely important, but an organization cannot get off the ground and succeed without a leader. Ideally, the champion or group of champions should be accredited investors with influence and connections within the community sufficient to attract other accredited investors as potential group members.

TABLE 4
Angel Investor Reasoning

QUESTION	TOP THREE ANSWERS
What do you think are the main reasons that business angel investors do not make more investments?	1. Lack of business proposals that match their general investment criteria 2. Lack of faith/trust in company founder/management 3. Lack of quality business proposals
Which of the following reasons do you think motivate your investors most to invest?	1. The opportunity to co-invest with other, more-experienced investors 2. The opportunity to learn from successful business angels 3. More trust in company founder and management
More specifically, additional knowledge on which of the following stages of the investment process will motivate investors to invest?	1. Due diligence 2. Pricing and structuring deals 3. Negotiating deals

Clear Reasons for Forming the Angel Group: Along with having a committed individual or group, an understanding of why people become angel investors, or conversely, why they shy away from angel investing, can be critically important in attracting members. Understanding your community is also essential, and you should evaluate your community's capacity to support an angel organization. As to reasons for becoming or not becoming an angel investor, we look at the results of the CVR 2003 angel group survey. Several questions were posed to existing angel organizations relating to angel investments. The results are telling as to why the number of angel organizations is on the rise. Table 4 lists the survey questions and the top three responses from angel groups.

Although these questions were asked of existing angel organizations, the reasons for establishing an angel group are the same, and the responses give good insight into the reasons more angel groups are being formed. Along with providing the social aspects of group interaction, angel groups typically fulfill many of the needs of individual angel investors and the limitations associated with solo angel investing, including:

- Angel groups provide more efficient matching of entrepreneurs and investors. Market recognition of an angel group and its particular investment focus leverages this public presence and creates a network of members to increase quality deal sourcing and comprehensive due diligence.

- The efficiencies of group due diligence and investment support cannot be emphasized enough. Individual deal screening is time consuming and inefficient. Few, if any, individual angel investors possess all the skills and knowledge necessary to accurately and objectively evaluate an investment opportunity. Group evaluation allows for "checks and balances" analysis by providing multiple points of knowledge about the market, management, and financial assumptions, and by encouraging group members to challenge assumptions and opinions in a way not typically done by individual investors.
- New angels can learn from experienced angel investors on all aspects and steps of investing.
- The combination of potential investment dollars either through an actual angel fund or through collective individual investors gives greater economic power and influence, which enhances deal flow and investment-terms negotiation.
- Angel groups provide the intangible values of camaraderie and sharing of common goals.

Make sure that your angel group plans include a clear set of reasons for establishing the group and that these reasons fit with prospective member expectations and interests. Consider many of these attributes outlined above in defining your vision, goals, and strategies.

Understand Why Your Colleagues Are Interested in Being Angel Investors: Even more basic than the question of why investors join angel groups is the question of why people become angel investors. One noted publication[9] ranks the motivations for angel investors in the following order of importance:

- Expectation of high financial reward.
- Playing a role in the entrepreneurial process.
- Fun and satisfaction of being involved in an entrepreneurial firm.
- Creating a job for oneself, and possibly some income.
- Sense of social responsibility.

Along with contributing to group learning and dynamics, angel organizations can also fulfill the motivations of individual angel investors. All these factors should be considered and constantly reviewed to ensure the success of any angel organization. Understanding the fundamental psychology of angel investors will bode well in structuring your angel group.

[9] Robinson, R.J., and Van Osnabrugge, M., "Angel Investing: Matching Start-up Funds with Start-Up Companies" *The Guidebook for Entrepreneurs, Individual Investors, and Venture Capitalists,"* Jossey-Bass Inc. 2000

Understand the Risks: The advantages and potential rewards of angel investing can be desirable and financially satisfying. Despite the fact that this Guidebook is intended to support and guide the establishment of angel organizations that best suit a community and group-investment focus, one must also be cognizant of the downsides of angel investing. Angel investing is a high-risk game. Angels typically invest at an early stage of company development, when the future is on paper and in the founder's dreams rather than in the bank. Angels also have some of the greatest potential for gain. Regardless of the outcome, however, all angel investors must be willing and able to risk the loss of their entire investment. Return on investment can often take several years, if it happens at all. This seemingly negative discussion is not intended to deter your endeavors to establish an angel investment organization but rather to ensure a good foothold in reality.

BUILDING THE FRAMEWORK (CREATING YOUR ANGEL GROUP)

Now for the hard part: selecting the right organizational, management, and membership structure for your group. You have many variables to consider, and it is important to establish some context and framework in order to make informed choices. The following decision-making matrix is intended to lead you to a comfortable and satisfactory answer for your prospective members and community.

With each step, background points will be laid out, numerous questions will be posed, pros and cons will be given, and reality points will be identified. Of course, the ultimate test is acceptance by your members. This Guidebook also describes a few existing angel organizations with different structures that have successful track records in attracting members and making investments. In addition, several initial documents are offered in the appendices as examples of working documents for your organization and are intended to be useful for multiple organizational structures.

As you go through the process of building your angel organization, keep in mind the following almost universal truisms:

- Angel organizations are generally **made up entirely of individuals,** although some groups do have entities such as venture funds and corporate sponsors as members. Entities typically have a different status, such as associate members. One of the concerns for any angel group is that membership becomes mostly sponsors, service providers, and people who are interested in observing, but not investing. Steps to avoid this migration in membership will be discussed later.
- Angel organizations represent an **active, rather than a passive, investment process.** Members are engaged in some way throughout the investment process. Individuals seeking only passive investment opportunities should consider venture capital funds or a private equity manager.
- The groups are made up of **individuals with common interests,** typically early-stage investments. Some groups, particularly in larger cities, may have an industry or market focus. This can influence potential membership by appealing to both those who would be attracted to your angel organization because of the particular focus (but do not necessarily have any background in the focused market) and those who you would be interested in joining your group because of their background and experience.

- Members have a **mixture of experience and backgrounds**, not only in particular industries, but also in professional skills such as management, finance, marketing, human resources, or research. Having members with different professional backgrounds can be critical in conducting due diligence on potential investment opportunities.
- With a few exceptions, **angels prefer to invest locally**. The reasons are several: from an interest in giving back to one's community, to ease of performing due diligence on the company, to interest in an ongoing relationship with the company and management.
- As discussed previously, but worth repeating, a successful **angel group must have a champion** or group of champions to ensure successful establishment and operation.
- Group members value angel group dynamics, the opportunity to learn from one another, and **access to superior deal flow.**
- Last, but definitely not least, a primary reason that individuals become angel investors is a **keen interest in capitalizing on high-return potentials**. We have already discussed maintaining a strong hold on the reality that angel investing is a high-risk proposition, and we must remind ourselves at each step that angel investors must be willing and able to lose their entire investment in the high-risk, adrenaline-pumping game of early-stage financing.

COMMUNITY ASSESSMENT

The first step in establishing an angel investment organization is to conduct a community assessment to better understand the nature of your investment community and potential group members. Assessments must be made in an objective manner. The very fact that you are reading this Guidebook indicates your interest in establishing an angel organization. However, you must be conscious of community limitations or industry focus that could hamper your attempt to establish a vibrant angel group or that might limit the type of investments available and, as a result, limit your membership.

The following table gives you categories for evaluating available data and general information in making your community assessment. No one community will have all these attributes. Nor will you find the relevant data for all categories. The more valuable part of this exercise is actually conducting an objective analysis of your community to identify community strengths and weaknesses in considering the viability of an angel group. You may find that, although important attributes are missing, your community is strong in other areas or has the means to develop those missing aspects. You may be able to complete the assessment with your local entrepreneurial-support community and without paying for an outside consultant.

TABLE 5
Community Assessment Questions and Process

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
Potential angel community Does your community have sufficient numbers of accredited investors to form a viable group? Is there a sufficient core of experienced investors or other resources to help with educating nascent angel investors?	**Review census reports, home values, and number of successful industries** (correlates to successfully exited executives). It may also be informative to compare your region to other parts of your state to understand any trends and stability in your region's wealth population. Along with the need to have a solid population of potential members is the need to have members who can share their experiences and expertise with new members. Angel investing is more sophisticated and involved than early investment dollars coming from friends and family, who typically invest out of affection and familiarity. Therefore, your members need the ability to have initial and ongoing education and training to improve potential investment performance and long-term return, thus creating a successful angel organization.	1. Does your community have a strong presence of wealthy individuals, especially those who have made their money through building their own successful company? 2. Does your community have a number of public company corporate headquarters (which would suggest high-net-worth individuals in senior positions)? 3. Does your community strongly support the arts and have a number of endowed organizations? (Also suggests high-net-worth individuals.)
Prevalent industries in region What established and developing industries are in your region?	**Again, census information can help you better understand your community.** Since angels generally invest locally, you need to make a thorough assessment of your regional industries to determine whether your particular goals or interests for the angel group fit with your community. For instance, if you desire a high-tech focus for your angel group, but the vast majority of industries in your region are agricultural or traditional manufacturing, you may have difficulties creating a successful angel group. Additionally, your regional industries should represent a good mix of markets that typically need start-up and further capital, with a healthy product or services market size attractive for acquisition or IPO.	1. How does your community compare in industry base, particularly high-tech or biotech, with other communities in your state and the nation in general? 2. Do these industries often create second- and third-tier entrepreneurs? 3. Do your regional industries often require start-up financing, and are they able to obtain funding locally? 4. Are the companies represented by your regional industries appropriate for liquidity events such as an IPO or acquisition by a publicly traded company?

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
Entrepreneurial pool Does your community have an active entrepreneurial environment?	**Assess the number of entrepreneurial companies in your community, including the number of companies funded. Additionally, assess the ongoing likely sources of cutting-edge products or services, such as from leading colleges in various disciplines.** For instance, your community may have a university, with colleges in the areas of applied physics or biochemistry. If there are no or few viable companies for investment and few sources of innovative products and marketing concepts, it doesn't make any difference how many high-net-worth individuals may live in your community — there won't be adequate deal flow for the group. Additionally, your community must be one that generally attracts entrepreneurs because it possesses many of the attributes described in this community assessment.	1. Do you have a number of young companies starting up in your area? (Your local business trade publication is often a good indication of the degree of entrepreneurial activity.) 2. Is your community considered healthy and thriving, as well as attractive to entrepreneurs? 3. Does your community have centers of higher education, particularly with graduate programs in the areas of engineering, science, or math? 4. Does your community have government-funded research centers?
Entrepreneurial infrastructure that supports, educates, and fosters entrepreneurs and new businesses Does your community have entrepreneurial centers and entrepreneurial education programs and associations?	**Make an assessment of the number of start-up business services and programs, as well as trade or industry associations, to get a better idea of entrepreneurial support in your region. Additionally, make an assessment of state and local tax incentives and other legislation and economic incentive programs that support and promote growth.** This analysis may also give you a better understanding of the prevalence of specific growth industries in your community. Even if you have a solid pool of entrepreneurs, the likelihood of developing successful businesses is diminished, or your community's potential will not be met, without an active entrepreneurial support system.	1. Do you currently have, or would there be an interest in conducting, regular entrepreneurial investment forums, business-plan competitions, and similar programs? 2. Do your community educational institutions have graduate-studies programs in business, and do they support entrepreneurial programs such as business-plan competitions?

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
	Often, experienced, cashed-out entrepreneurs will volunteer with entrepreneurial programs as mentors, program managers, or trainers as a way to give back to their community and stay involved. Investment forums can also be a terrific mechanism for highlighting the cream-of-the-crop companies seeking financing, since these forums typically have a selection committee to choose the companies to present, as well as a coaching team for each selected company. The political and business environment must also be conducive to the growth of young companies. Active Economic Development Councils, Chambers of Commerce, and state legislators can be critically important and essential. Even the presence of a strong business journal can be an indicator of a healthy environment that fosters entrepreneurship.	3. Are there trade industry associations in your community to support and foster existing and new companies, such as companies related to software or biotechnology? 4. Are there non-profit organizations in your community with a specific mission to support and foster the growth of entrepreneurial businesses, such as MIT Forum or Young Entrepreneurs Organization (YEO)?
Support services/teams Does your community have a solid pool of experienced service providers and potential senior management?	**Review professional source guidebooks, and analyze the number of firms and individual professionals that list services and skills relevant to early-stage companies. Assess the talent pool for key team positions such as CFO, CTO, or CSO by reviewing the presence of regional graduate programs and professional association memberships and by analyzing existing business human capital shortfalls.** Without excellent professional support, bright and ambitious entrepreneurs may struggle to create a solid company, placing your investment capital at greater risk. In addition, investment-grade companies are not made up of a single individual, and the presence of key talent is critical to a successful company. Any entrepreneur who believes he or she can do it all is someone you want to shy away from, as none of us knows everything. Effective entrepreneurs recognize their limitations as well as their talents.	1. Is there a good base of young and/or experienced talent for key roles in companies through local graduate school programs, optioned-out high-tech employees, successful corporate managers or doctoral researchers? 2. Does your community have legal, accounting, marketing, and other services experienced in early-stage company development and financing? Do these service providers often speak on relevant topics at various programs?

CATEGORY	ASSESSMENT TOOLS OR INFORMATION	ASK YOURSELF
Follow-on funding Are there adequate local sources for sizable and later-stage financing?	**Make an assessment of regional venture capital funds, mature companies for potential partnership and funding, and banking resources for debt and capital equipment financing.** Many entrepreneurs will need funding past the initial angel round. As a result, additional funding sources become absolutely essential, if for no other reason than to protect your angel investment. With the recent dramatic drop in venture capital financing, some angel organizations have recognized the need to provide funding for companies past the traditional early angel round. Venture capitalists are funding fewer and fewer early-stage deals and, as a result, angel investors must either step up to further fund an investment or risk loss of their money. Of course, many businesses require funding beyond the means of most angel organizations, and available sources of subsequent funding must be known. Angel organizations that have connections to, or ongoing relationships with, venture capital funds will have the advantage of potential follow-on funding and better screening of early investments through reciprocal referrals from venture capitalists.	1. How many VC funds are located in your community or general region? 2. Are there smaller VC funds that may invest in earlier-stage companies? 3. Could your angel organization support any and all financing needs, and would this fit with member interests?

Keep in mind that any one community seldom has all of the attributes for supporting an angel organization, and interpretation of facts and information should be balanced against your assessment of the relative importance of the various factors in your community. Also, your prospective group may decide to lead your community in the development or expansion of certain activities, such as entrepreneurial support services or investment forums. Therefore, the community assessment is really intended to give you a better understanding of the potential for success of your angel group and, possibly, also determine the best investment focus for your organization.

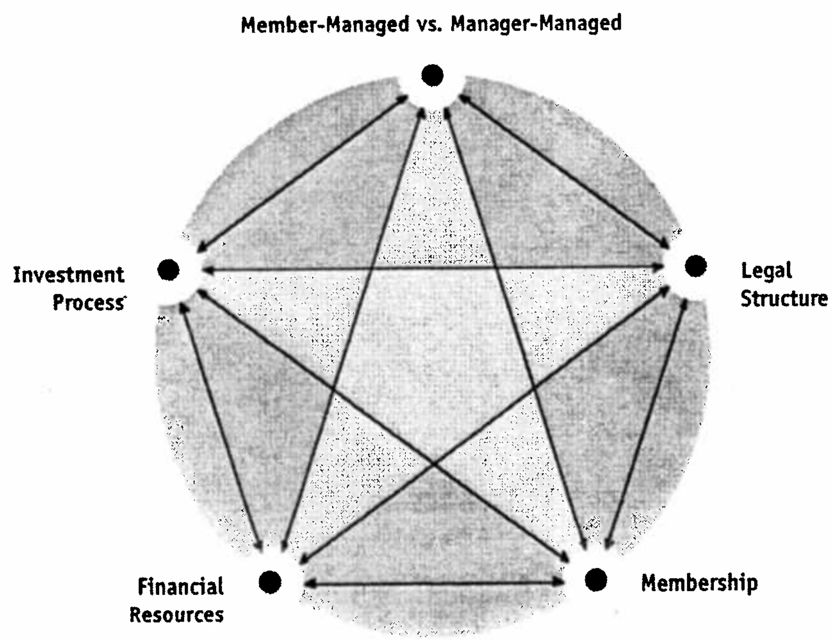
Now that you have completed your community assessment and determined that your community has many of these attributes, it is time to move on to the development of your angel organization.

SELECTING A STRUCTURE

A first step in setting up an angel group is determining the right organizational structure for your community and group members. The following matrix emphasizes the interdependency of your various choices or decisions related to the structuring and operation of an angel group. Nearly every decision you make can affect previous assumptions or decisions. As such, continue to challenge your previous choices or decisions for fit and appropriateness with each step. Keep in mind the following:

- There is no one best model for angel groups. The angel organization "industry" is still in its infancy in many respects, and only limited research and evaluation have been conducted to date. As a result, one cannot draw any conclusions about the superiority or success of one particular model. In fact, anecdotal evidence suggests that many models have been successful (if we can even agree on the measure of success).
- **Form must always follow function.** Do not choose a particular legal model or management structure and then try to shoehorn your members into a model that does not fit their interests or investment orientation. Let your members' interests and comfort levels guide your ultimate decisions.
- **Remember to keep your knees bent and challenge your previous decisions.** As much as you would like the process of angel group development to be straightforward, your willingness to listen to input and adjust previous assumptions will bode well in creating a successful organization.

FIGURE 1
Decision Matrix



DECISION STEPS

MEMBER-MANAGED VERSUS MANAGER-MANAGED

One of the fundamental decisions to make is whether your organization will be managed by the members or by a professional manager. By its very description, a member-managed (or member-led) organization requires active member involvement in nearly all aspects of operation. Member-led organizations usually hire administrative support to handle matters such as member communications, meeting coordination, and database maintenance.

In contrast, a manager-managed (or manager-led) organization employs the services of an individual(s) with experience and background in the investment process and/or in the industry in which the angel organization intends to focus its investments. Typically, a manager does much of the up-front work of vetting possible deals, conducting initial interviews with companies, coaching entrepreneurs for presentation to the angel group, handling member communications and relationships, and even at times making recommendations on investments and negotiating investments on behalf of the organization.

This manager is not the same as a general manager of a venture capital fund, which has the authority and control over all investment decisions. Instead, an angel group manager manages the group's processes so that the members can focus on making investment decisions.

Some of the pros and cons of these two basic structures are illustrated in Table 6.

TABLE 6
Structural Pros and Cons

MANAGER-LED	MEMBER-LED
Pros: Professional operation; screening and investment activities conducted by experienced management; manager handles member relationships	**Pros:** Greater connection of members to group and activities such as deal screening, member recruitment, etc.; involvement provides for hands-on education for members
Cons: Operating costs are higher to cover professional management income, benefits, office space, and administrative support	**Cons:** Ability to maintain consistent volunteer commitment of members; potentially inconsistent operations

STATISTICS ON STAFFING: *In reviewing the results of the 2003 CVR survey of angel organizations, the majority (61%) of responding organizations had paid professional staff. Interpretation of this percentage is difficult because organizations with paid management may be more likely to respond to a survey and because the interpretation of "paid manager" may differ between groups. However, if you take into consideration the number of affirmative answers regarding the prevalence of paid management, along with the presence of an executive director and/or administrative staff, most organizations answered in the affirmative. Again, the exact percentage is a bit difficult to calculate because of the uncertainty of individual interpretation of terms and the rate of responses between organizations with structured management (even if only administrative support). As will be discussed later, several factors will influence your decision on staffing, including the organization's legal structure and budget (and how you finance your group).*

The following questions will help you make the fundamental choice between a member-led or manager-led organization. Keep in mind that even with member active participation in some or all duties and organizational activities, a manager may still be quite appropriate, particularly with large groups (more than 75 members); many groups with actively participating members have executive directors, and nearly all have some type of administrative support. A more detailed discussion of various group activities and duties is under "Operations" in this Guidebook.

TABLE 7
Member-Led versus Manager-Led Groups

QUESTIONS	YOUR ANSWERS (1 or 2)*
1. Are members interested in reviewing all applications for presentation to the group, and do they have the time to do so?	1 or 2
2. Are members interested in coaching companies for presentation to the group, and do they have the time to do so?	1 or 2
3. Do members prefer to make all decisions on, and have direct involvement in, operational structure, membership interaction, Web site content, public relations, and budget?	2
4. Will members be willing to contribute time on a regular basis to the executive and/or operational management of the group, including board activities, committee work, membership recruitment and relations, deal screening, due diligence, and negotiation of investments?	2
5. Are members not willing to pay for professional staff, which can be a significant expense, in addition to covering the operational costs?	2
6. Would members prefer to have responsibility for conducting many of the activities related to operating a successful angel organization, including member recruitment, meeting planning, deal sourcing, deal screening, due diligence, and investment negotiation? Do members have the background and expertise to conduct these activities?	2
7. Would members prefer to hire administrative support staff to handle communications and meeting planning, but leave other functions up to members?	1 or 2
8. Do you plan to operate your organization as an angel fund, with member-committed investments? If no, managers are not necessary, although even some organizations in which members make individual investment decisions have paid professional managers. Some member-determined investment groups will also have a sidecar fund, or a fund that invests alongside investments that may be made by the angel organization. Again, this type of angel group would be well served by professional management. If yes, a manager-led organization is probably more appropriate because of the need to coordinate handling of investments. Additionally, a strong manager is typically a deciding factor for individuals considering membership and commitment of personal funds.	1 or 2 (see discussion)

*1 = manager-led group most appropriate. 2 = member-led group most appropriate

Examples of manager-led and member-led organizations: Since this first decision point in your group development process is so important, an example of each structure may be valuable to get a better understanding of your choices.

An excellent example of a manager-led organization is CommonAngels in Boston, Massachusetts (www.commonangels.com). The organization has an angel group of approximately 50 members, who make individual investment decisions. In addition, CommonAngels has a sidecar investment fund (i.e., a committed investment fund related to the angel organization that invests through a separate investment committee). An office manager and associates (often MBA students) support the managing director. This is a structure that supports a larger, more diverse organization and provides the manager the ability to give attention to the big picture as well as to details regarding member communications and recruitment, deal screening, due diligence, investment negotiation, and investment follow-up. Such a staff is an investment that needs to be aligned with your organizational needs and investment strategy. Much of the value and benefit of a manager-led organization comes from the combination of management skills and experience previously discussed, which CommonAngels most definitely possesses.

When we talk about member-led organizations, Tech Coast Angels in Southern California represents an effective operation. Volunteer members manage the strategic as well as the day-to-day operations of Tech Coast Angels. Members are invited and encouraged to attend deal-screening meetings, which occur twice a month, with member attendance averaging 40 to 60% at each screening meeting. All intrinsic parts of the investment process are done by members, with support from part-time administrative or professional support of a deal-flow administrator and screening director, who handle investment mechanics such as assisting entrepreneurs in completing applications, arranging meetings, etc. Members are experienced entrepreneurs who have been through it all, making them knowledgeable investors and potential mentors. In fact, about two-thirds of members have CEO experience. Tech Coast Angels has three chapters in San Diego, Orange County and Los Angeles, and the entire Tech Coast Angel network shares deal flow, expanding the investment-opportunity pool for members.

Finding the right manager: If a manager-led model fits your functional intentions and is aligned with member needs and interests, you should carefully consider desired manager attributes. Cohesiveness between the manager and your angel group can be the single most important factor in the success of your organization. As such, consider the following combination of skills:

- Business expertise and savvy;
- Financial intuition;
- Motivations parallel to those of the group;
- Domain or investment-focus expertise;
- Organizational operation insight;
- Communication skills and diplomacy;
- Leadership qualities; and
- Process-management skills.

Interestingly, these skills also are considered important in entrepreneurs, and should also be part of your due diligence review of management.

Remember that a manager is more than administrative support The manager should be a leader, coordinator, decision-maker, spokesperson, and den mother for your angel group. Many angel groups prefer to retain these roles in its members and may choose to employ an executive director, who typically handles member relationships, communications and other operational matters, but plays a minimal role in the investment process. Certainly some of the skills listed, particularly the second half, would be valuable skills for an executive director. Many groups may have only administrative staff to coordinate meetings and communications, and all other functions are left to members. As has been stated before and will be repeated throughout this Guidebook, any of these models is perfectly acceptable and viable; the final choice depends entirely on your needs and member interests.

LEGAL STRUCTURE

Multiple legal structures work for both member-led and manager-led organizations. The preferred structure will again depend on your group's desired complexity and level of member involvement, as well as appropriateness for your community. Member familiarity with a particular structure and the angel investment group concept may be factors in legal-structure choice. The five currently prevailing angel organization legal structures are:

- **Affiliation without Formal Structure:** A loosely affiliated organization is appropriate for member-led groups, particularly those with a smaller number of members and/or early in their operation. Informal groups usually work well up to around 15 members, when more structure is needed for basic operations. Part-time administrative staff may be helpful to handle matters such as member communications and meeting logistics. Generally, these groups have regular meetings, with any and all investment decisions made on an individual basis. Members usually are active in all aspects of the group, from screening business plans to membership recruitment.

Obtaining financial support for informal groups can be challenging, depending on the desired level of sophistication. Costs can include items such as member communications and information management, meetings, and due diligence. Typically, cost coverage must come from the members, with the advantage that costs are usually relatively low because of the lack of formal structure and limited membership. No particular documentation is necessary, but the group may wish to have some agreement or code of conduct between members requiring that they respect one another's confidences. Additionally, decisions regarding membership should be made through group consensus to maintain the desired culture and intimacy of the group.

Informal groups work best with a small number of members. When membership grows, structure becomes a necessity to handle group issues and operations. Affiliations work well as a first step when introducing the concept of organized angel investing to a community. Individuals may have trepidations about plunging into a highly structured organization or actual angel fund, and they may prefer to build a trust level before developing a more formal organization. Similarly, some investors are fiercely independent and private about their investment decisions, and while they appreciate and enjoy group camaraderie, they consider the actual investment choice and process to be their own business. For these investors, an affiliation is a good choice.

AFFILIATIONS MAY BE BEST FOR:

- *Small groups (fewer than 15)*
- ***Getting started, before membership is fully identified and uncertain as to group desires and needs***
- ***Each member desires to remain independent in all aspects of investment process***

- **Nonprofit Corporation:** Many organizations that start out as informal groups to test member interest will migrate toward a more formal structure. As discussed above, this is particularly true when the group grows and adds members. The nonprofit corporate structure allows for easy establishment of formal decision-making processes for handling group dynamics and operations through a governing board. The nonprofit structure, as with other formal structures discussed below, facilitates the establishment of banking accounts and the hiring of staff and enhances the group's ability to enter into contractual arrangements.

The term "nonprofit" generally refers to a corporation formed under a state nonprofit corporation statute. Typically, nonprofit organizations are either mutual-benefit entities, such as private clubs, which exist for the benefit of their members, or public-benefit entities, such as community food banks, which exist for the public benefit. States generally have one statute that governs for-profit corporations and another that governs nonprofits. Thus, state law determines the nature of the entity to be formed and governs its day-to-day operations.

A "tax-exempt" organization is one that the Internal Revenue Service (IRS) has recognized as meeting certain tax-law requirements for exemption from federal income tax. Most tax-exempt organizations are nonprofit corporations or charitable trusts. The fact that an organization is formed as a nonprofit corporation under state law does not make it tax exempt. With minor exceptions, an organization must file an application for federal tax-exempt status with the IRS and receive a "determination letter" granting the exemption. The application is made on IRS Form 1023 (for Section 501(c)(3) organizations) or Form 1024 (for other organizations). The Internal Revenue Code grants an exemption from federal income tax to more than 25 different categories of organizations, with the most prevalent sections for angel organizations being 501(c)(3) or 501(c)(6), educational pursuits or trade associations, respectively. Donations to 501(c)(3) organizations are tax deductible, while donations to 501(c)(6) organizations are not tax deductible. This brief discussion of tax-exempt organizations should not be interpreted as minimizing the considerable requirements to qualify for a tax-exempt status. As with development of any organization, one should consult a professional skilled in the area.

As evidenced by the statistics outlined below, nonprofit organizations have been a frequent choice for angel groups. To obtain tax-exempt status, an organization must fulfill tax-code requirements for purpose and structure and then remain consistent with them to maintain the status. These requirements can be restrictive for some groups, particularly those intending to invest through the group organizational structure. This may also be an unworkable structure if you desire to compensate the group manager or others through a portion of the investment, sometimes called the "carry."[10] On the other hand, tax-exempt status is well suited for groups in which individual members make their own investments and the angel group exists to promote the group's purpose or to educate its members and others on angel investing.

The **Sierra Angels** is an excellent example of a 501(c)(6) organization. Soon after launching the angel group in the **Lake Tahoe area of Nevada,** the members discovered a lack of regional management talent and skilled labor. In addition, there were few links between the business, education, and research communities, and limited access to venture capital

[10] You may still be able to make this work later if all investments are made (and carry given) through a structure separate from the operational organization. As mentioned, consult a professional for advice on structure.

and lending sources. As a result of these deficiencies, Sierra Angels expanded their charter in order to play a key role in the economic development of the region. Today, Sierra Angels is definitively involved in many aspects of educational development and economic diversification in Nevada. These educational activities provided the ability to file for and receive a 501(c)(6) tax-exempt status.

Examples of member activities include: participation in the drafting of the master plan for University and Community College System of Nevada; participation in the development of the University of Nevada-Reno Strategic Plan; active members on the advisory boards for the Colleges of Engineering and of Business Administration for the University of Nevada; Nevada Center for Entrepreneurship and Technology (a public/private corp.); Golden Capital Network; and trustees for the Sierra Nevada College, helping the college become a distinctive, focused, liberal arts college with prominent majors in entrepreneurship, computer science, entertainment technology, and environmental science and policy.

Another excellent example is **Angel Healthcare Investors, LLC,** in **Boston** which, like so many other angel groups grew out of the founders' common professional background and their mutual interest participating in early-stage investment opportunities, through a community of collegial, well-connected and talented health-care professionals with a desire for yield of economic and social benefits. By developing clear processes and systems (some of which will be discussed later in sections about deal flow and investment), supporting an emerging culture and building traditions, and educating and communicating both within the group and in the marketplace, AHI has become an innovative, responsive, cohesive, and respected angel organization. All investments are made through separate one-time investment vehicles, which, in AHI's case, is a new LLC for each investment (as opposed to individual participants writing checks directly to the company). Each investment then has a designated portfolio monitor — either a staff person or a group member — to observe the investment and report back to the group.

NON-PROFIT ANGEL GROUPS MAY BE BEST FOR:

- ***Nearly any group other than an angel investment fund in which members share in investment profits and losses through the fund structure***
- ***Even with angel funds, group operations may be supported through a non-profit structure, and investments can be made through separate legal structures such one or more LLCs***

- **Limited Liability Company:** LLCs are emerging as a popular legal structure for angel organizations. LLCs are more complex in operation, with capital accounts and profit/loss distributions, but they do provide a number of benefits. Individuals can be members of the LLC, with one or more managing members. Officers can be elected just as with a traditional corporation. LLCs can have a board (sometimes called a "Board of Managers"), which functions much like a corporate board of directors and serves many of the same purposes of operational oversight, strategic planning, and approval of certain organizational matters. The LLC structure provides considerable flexibility in membership (both individuals and entities can be members) and has the possible benefit of being taxed as a partnership. The structure works well for both manager-led and member-led organizations, with statistics showing a fair balance between these two management structures. LLCs are particularly well suited for angel groups that require an up-front commitment of capital from members and then make investments through the fund (as opposed to individual investments). A few angel groups create separate LLCs for each investment, with the LLC members being those members of the angel group choosing to participate in that investment.

LLC STRUCTURES ARE BEST FOR:

- *Angel investment funds, although the structure can be used for any angel group. As noted above, LLCs have a more complicated tax structure with a partnership taxation structure, so if your group intends to have individual members make their own investments in portfolio companies (i.e., no pooled or combined funds for investment), a simpler structure such as a non-profit corporation may be best*

The Washington Dinner Club (Washington, DC) demonstrates the success of a manager-led limited liability company (LLC). The Dinner Club was formed by two regional investors who successfully established three such groups. This angel group structure allowed for two classes of membership interest — one for individual investors with one vote per member and a second class for institutional investors, which had no voting rights. In the third Dinner Club, membership was capped at 75 individuals and 10 institutional members, with a minimum of 30 individual memberships in order to activate the LLC. Individual members were required to make an initial capital commitment of $50,000, with a total of $150,000 investment commitment over the LLC term. Institutional investors were required to make a total investment commitment of $500,000 in similar increments. The Club had an operating budget (roughly calculated at 2 to 3% of total subscribed capital) for its monthly dinner meetings, support services for meetings and due diligence, accounting, and other operational expenses. Managers received a management fee from the operating budget and a 15% carried interest from any portfolio gains, on a deal-by-deal basis. The managers were responsible for the day-to-day operations of the Club, including member communications, administrative matters, and deal flow. Members participated to varying degrees in due diligence, investment terms negotiations, and post-investment relationships. Reflective of angel groups, all investments were made only upon membership approval.

- **Corporation (For-Profit) and Subchapter S Corporation:** A traditional corporation is the legal structure of most publicly traded companies, with shareholders, boards of directors, and corporate taxation. The 2003 CVR angel group survey shows that approximately 9% of the responding angel organizations have a traditional corporate structure. A corporation can work well as the parent or holding company for more sophisticated angel organizations desiring a different entity for management functions that are separate from the investment vehicle.

  Subchapter S corporations provide a group with all the functional and organizational attributes of a corporation, but with partnership tax treatment. However, S Corporations are less flexible than LLCs. In contrast to LLCs, S Corporations may have only individuals as shareholders, and only one class of stock may be issued. These limitations can create problems for members wishing to run their investment portfolio through a corporation or some other legal organization, or if you desire to have different classes of ownership, such as a different class for each investment, which will be made up of different individual members for each investment. As a result of these limitations, this structure is seldom chosen by angel organizations.

- **Limited (Liability) Partnership:** Venture capital funds are now almost universally structured as LPs or LLPs. Investment decisions are made by the general partners, with the limited partners taking a passive role, which is legally mandated for limited-liability status. Because angel groups are made up of active investors, this legal structure is seldom seen and may be present only in limited side funds (funds that operate alongside an angel group as an independent investment vehicle).

  One possible use of an LP is when management is compensated through a percentage of each investment. For those groups that have a dedicated fund with long-term compensation to professional staff (i.e., "carry") as well as individual angels participating directly in investment opportunities, an LP can serve as an intermediate vehicle between the fund and the manager to hold the carry. This intermediary gives the manager several advantages:

  - Employees receive the legal benefit of a corporate shield;
  - The manager can change staff over time without the complexity of swapping general partners or the manager itself; and
  - Non-accredited investor employees can receive part of the carry by being members of the LP. Typically they cannot be direct participants in the fund itself without damaging its status as an accredited investor.

STATISTICS: *Looking at existing angel organizations sheds light on proven models. According to the 2003 CVR angel group survey:*

- *44% of responding groups were nonprofit and/or 501(c) organizations*
- ***38% were limited liability corporations***
- ***9% were corporations***
- ***7% were informal groups or affiliations***
- ***General and limited partnerships were not favored legal structures***

Questions for Choosing Your Legal Structure:

The following questions will help you choose a legal structure for your organization. Before making a final decision, however, you should obtain professional advice on this issue.

Q. *Do you intend to require member investment commitments to create a pooled fund?*

If yes, an LLC structure would work well as the operational structure as well as investment vehicle.

If no, almost any other structure will work, depending on other factors such as the desire for greater organization (therefore, not a simple affiliation) and the anticipated level of governance of group activities. Therefore, the choices can be:

- **Affiliation without formal structure**, which is not recommended for groups with more than 15 members, due to the necessity for organizational structure, operation, and governance with larger groups.
- **LLC** can be used for all intended operational structures. LLCs provide the protection of a corporation and are taxed as a partnership. Member capital accounts and profit-and-loss allocations can be confusing, so consult a professional. Because of these various accounting and tax aspects of LLCs, some groups have used the non-profit structure (whether or not federally tax exempt) as a simpler, straightforward structure with governance attributes similar to a standard corporation. This latter point of avoiding a complex legal structure is particularly true for member-led groups.
- As discussed above, **non-profit corporations** can be a good choice for groups with individual member investments. A non-profit would not be appropriate for a fund or group that intends to invest through the group legal entity and/or distribute returns through the entity, since non-p rofits cannot provide shareholder benefits. Whether or not your group files for tax-exempt status is another level of decision-making that involves making real, conscious choices about group focus and mission.
- **C corporations or Subchapter S** corporations can also be used but do not provide any special benefit outside the other structures.

Q. *Would members prefer little or no structure, and do you intend to keep membership to a small, intimate group?*

If yes, a simple affiliation can be appropriate.

If no, consider other priorities for your group, such as:

- A need or desire to have a tax-exempt structure to avoid any tax issues, which suggests a **501(c)** structure, assuming the organization's operational purpose and other relevant factors align with requirements for obtaining and maintaining tax-exempt status.
- Members' desire to have considerable input on operational matters. Along with suggesting a member-led rather than a manager-led organization, significant member involvement can be accomplished through any of these legal structures. An **LLC** or **non-profit corporation** can provide for member involvement, although typically a smaller set of individuals act as the managing members or board of directors, respectively. As noted above, **LLCs** work well for manager-led funds, even with group members desiring active involvement in group management or governance, since the manager can be designated as the managing member or given other designated authority, with angel investors making up the board of managers.

Table 8, on the following page, gives a summary comparison of the various legal structures.

TABLE 8
Legal Structure Comparison

[illegible]	LIMITED LIABILITY COMPANY (LLC)	NON-PROFIT CORPORATION	501(C) TAX-EXEMPT ORGANIZATION	C CORPORATION (STANDARD)	S CORPORATION	[illegible]
TYPICAL investment model	Investment fund (can be used for member-determined investment groups)	Member investments (can be a separate or parent entity for group operational purposes, with a separate entity as an investment fund)	Member investments (can be a separate or parent entity for group operational purposes, with a separate entity as an investment fund)	Member investments (can also be the management vehicle with a side fund for group investment)	Member investments (could also be used as an investment fund but limited to one class of stock, and only individuals may be shareholders)	Rarely used, typical VC structure
Liability	Limited	Limited	Limited	Limited	Limited	Limited for limited partners, liability for general partners
Governance	Board of Managers	Board of Trustees/ Directors, depending on whether a public-benefit or mutual-benefit organization	Board of Trustees	Board of Directors	Board of Directors	General partners
Taxation	As a partnership	At corporate level (as non-profit corporations cannot have shareholders)	No tax consequences and no shareholders	At corporate level or double-taxed on dividend distribution	As a partnership	As a partnership
Membership	No limit on member numbers generally. If a fund, the operating documents often have a maximum number of members relating to fund size	No limit on member numbers; no shareholders in non-profit, therefore not appropriate as an investment vehicle (look to LLC or for-profit C corporation if desire group investment structure)	Same as non-profit corporation	Members may also be shareholders, and, as such, this structure can be used as an investment vehicle (but be aware of double-taxation issues)	Only individuals may be shareholders, and only one class of stock is permitted	Ownership is by general and limited partners, the latter being partially defined by their non-involvement in management and operations, thus not generally appropriate for angel groups

INVESTMENT STRUCTURE

Angel group investments can be broken down into essentially two forms:

Group Investment

- **Pooled funds** with each investment: Some groups combine the financial power of individual investments into a group or pooled investment, giving the group collective negotiation power.
- **Pledged or committed funds** are invested by group decision. Upon majority group affirmative decision, the group invests a defined amount. The investment amount can be decided by vote of committed and pledged fund members or by individual members for pledged funds. Additionally, the manager can recommend an appropriate investment amount based on company analysis. No respondents to the 2003 CVR survey required unanimous affirmative group vote for investment.

DEFINITIONS: *"Pooled funds" refers to a process in which individual members make their own investment decision, and then the group combines all member dollars into a single investment.*

"Pledged funds" refers to member commitment of a certain dollar amount, but the money is not transferred to the angel organization until needed for investment. The amount invested can be a group decision of an investment amount, or a group may allow individuals to decide personal investment amounts, with the latter having an annual investment requirement.

"Committed funds" require that members place their investment amount in the fund upon membership acceptance, or in staged and timed quantities for cost coverage and investment purposes.

Even with group investments, most organizations allow members to make additional, separate investments in companies chosen for group investment, and certainly anyone is entitled to make any investment in a company not chosen for group investment.

Individual Investment

- **Based on group due diligence**, individuals can then decide if a company fits their planned investment criteria and portfolio. As with a pooled fund, individual investors can combine their funds into a single investment vehicle, such as an LLC (assuming that everyone is an accredited investor). The basic difference between this approach and the pooled funds approach is the understood intent and the group's defined investment process. In other words, with a pooled fund, group members understand that investments will be made through a group decision process, with pooled or combined funds invested into the portfolio company. On the other hand, even with group due diligence, an angel group set up to allow individual investment decisions does not have the assumption of collective investment decision or investment, but rather each angel investor makes their own decision for investment. From this individual decision, based on group (or individual) due diligence, the group can always decide to combine their investment amount into a single investment such as through an LLC.

- **Based on individual assessment,** which typically relates to fairly informal groups, or a circumstance where only one member is interested in the company.
- **Side-fund investment with individual additional investments** can work well, with the side fund conducting much of the due diligence and sometimes leading the investment.

DETERMINATION OF MEMBERSHIP

When asked about having established membership criteria in the 2003 CVR angel group survey, all responding groups answered in the affirmative. Nearly all angel organizations require that members be accredited investors. As discussed earlier in this Guidebook, companies prefer to present solely to accredited investors to allow for qualification under regulatory exemptions from certain registration, information, and other requirements of federal and state securities laws. As a result, companies prefer to avoid non-accredited investors (for whom at least the information-disclosure requirements would apply). Therefore, angel organizations with all (or essentially all) accredited investors are more likely to attract strong investment opportunities.

One must consider numerous factors when determining the nature and attributes of membership:

Selection:

- *Membership Numbers:*
  - Depending on your angel group's goals and purpose, you may wish to limit the number of members. For instance, if the model that most ideally fits your interests and those of your members is to establish an angel investment fund with up-front fund commitment, you will want to set a defined size for the fund and a minimum investment per angel investor to give potential investors/members an understanding of the intended fund size.
  - On the other hand, informal angel groups often limit membership to maintain a certain culture or to assure the continued cohesiveness of the group.

STATISTICS: *Number of members by organizational structure — Looking at the statistics from the 2003 CVR survey, we see various legal or organizational structures with the following membership numbers:*

- *Informal Affiliations: Typically not more than 20*
- *Non-profits: Groups range from 25 to 125 in members*
- *LLCs (typically funds): Many of the funds cap membership at 50 or 75*

- *Membership by Invitation Only:*
  - Formal groups usually have a membership committee, with responsibility for member recruitment and selection and for ongoing member relations. Most groups appear to require a current member's recommendation or sponsorship for a new, potential member. With few exceptions, angel groups require members to complete a membership application, which typically contains a statement regarding accredited-investor status and recognition of the organization's code of conduct/ethics. Most groups require annual renewal of membership, with the reaffirmation of accredited-investor status and a pledge to group philosophy and conduct requirements.
  - Be sure that membership-recruitment objectives and requirements are clearly communicated to all prospective members. Member applications should be reviewed, and new members should receive introductory materials clearly stating the group's organizational philosophy, goals, objectives, rules of conduct, and code of ethics.

- *Membership Tiers:*
  - Individual members are a given, but some groups offer other tiers of membership. Affiliate membership may be offered to venture capital fund representatives. The VC fund could have a range of member rights, from attendance at meetings only to full participation rights in any deal. Whether or not a VC fund or sponsor is a voting member of your angel group is an individual choice; just be careful that, if voting rights are given, control is not inadvertently shifted away from the angel members. The advantage of including VC funds at some level of membership is the reciprocal value of sharing deals. This same point can create a disadvantage for some, with the fear that the VC will scoop the good deals out from under the group. These concerns can be alleviated to some extent by requiring VC funds to share deals in order to be members. Similar to VCs are investment bankers and broker-dealers, although angel groups must be more careful with their accredited-investor status. The same criteria should be used for these entities, with the additional requirement of no meeting solicitation (see discussion below on sponsorship).

- Depending on group financial resources, sponsor memberships may be attractive. The next section of this Guidebook will discuss costs and the options for coverage, but for purposes of the discussion, assume that you have decided to have some costs covered by outside entities. Professional service organizations, such as law and accounting firms, will fund angel organizations or events related to early-stage companies, wealth management, and other areas of their market focus. If an entity agrees to sponsor an organization or event, fairness and good business dictate that some benefit should be provided for the pledge, although group membership is not typically a benefit. The rub is how to provide these benefits without your group meetings turning into a networking event for service providers rather than focusing on deal screening and investment analysis. Some mechanisms to assure meeting focus include limiting the number of sponsors and sponsor representatives at each meeting and controlling any and all membership lists and correspondence. Benefits that may be provided to attract sponsors include introduction of guest speakers, opportunity to conduct member training sessions, sponsorship of the angel group's Web site, and placement of marketing materials and spiffs at meetings.

- *Dues and/or Investment Pledge:*

  The expenses of running an angel organization must be covered somehow (see the list of possible costs below). Expecting members to continually donate materials, cover mailing expenses, or volunteer administrative and other support services is unrealistic, unprofessional, and short lived. Members should expect to pay dues to cover costs. The discussion in the Group Operations section, which begins on page 40, as well as Appendix 5, provides a sample budget calculation for estimation of costs. Also discussed in Group Operations are various sources of funding, including a percentage of pledged funds to cover management and operational costs for angel funds.

- *Desired Culture:*

  Groups often limit membership, if for no other reason than to maintain a desired culture. Intimacy and frankness of discussion may be overriding goals that naturally limit the number of members. On the other hand, many groups find advantages in large numbers because of the resources available through better potential deal flow, the opportunity to make larger deals, and a greater pool of resources in membership skills and background.

Never underestimate the value of defining your culture. People are attracted to a group not only because of tangible member benefits, but also because of group goals and objectives, existing members, group reputation, and group dynamics. A well-understood membership-selection process helps to maintain the group's desired culture and a commitment to the desired group personality.

Membership Questions:

The following questions may help you better articulate your membership structure and membership qualifications.

Q. *Will the group have a particular investment focus, such as software, telecommunications, biotech, or consumer products? Will you seek members with specific backgrounds or expertise?*

- If yes, your membership process should include a clear definition of group investment focus, and your membership recruitment should focus on individuals with experience in the relevant industry and interest in such investment directive.

  You may wish to double-check your community assessment to ensure that your community has adequate interest and entrepreneurial base for a focused group; otherwise, you will need to consider a broader geographic investment range.

Q. *What will be the criteria for membership, other than the requirement that members be accredited investors?*

- Other membership requirements could be:
  - Particular expertise, such as marketing or finance
  - Specific background in an industry or market
  - Geographic
  - High net worth
  - Gender
  - Investment commitment
  - Previous investment experience
  - Time commitment

Q. *Should there be different tiers of members (e.g., individuals, VCs, sponsors)?*

- If yes, consider:
  - Different membership fees for VCs and other entities, usually higher than individual fees
  - Different fee for members outside your regional area (if accepting such members) and providing for their attendance at some percentage of total annual meetings (with corresponding reduction in fee)
  - Sponsors are generally not provided membership but rather allowed attendance at meetings for a defined number of representatives
  - Membership-fee amount depends on costs and other sources of revenue, as well as membership-fee tolerance

Q. *Will there be a limitation on membership numbers? Keep in mind that the larger the group, the greater the associated expenses in terms of communications, need for formality of operations and structure, meeting logistics, etc.*

- Will your angel group be a fund?
  - If so, your membership will be capped by the fund amount
- Do you desire a small, intimate group without any formal structure?
  - If so, your group should be no more than 15 members (as a guide) to prevent the necessity of legal formalities and administrative support that comes with larger groups
  - If not, your size depends on your ultimate group mission and goals (notwithstanding fund member limitations)

Q. *What will be the cultural atmosphere of your group? What are your priorities?*

- Everyone desires some cultural identification for their group. The group champion and founding board should spend time discussing and articulating values
- Some cultural attributes to consider are:
  - Intimacy
  - Learning environment
  - Social
  - Networking
  - Experience sharing
  - Pure investment
  - Safe environment
- Setting cultural aspirations can be easy but preserving more difficult. This can be accomplished through:
  - Clear articulation of culture in membership documents and on group Web site
  - Regular reminder to members
  - Consideration of desired culture when considering other types of membership such as sponsors or VCs
  - Design meeting agenda to meet cultural goals
  - Membership limitation may also be important

Q. *Are members willing to invest considerable time in group governance, management, and operations?*

- If no, be sure you have considered a manager-led structure
- If yes, and depending on the extent of member willingness to volunteer, a member-led structure can be quite effective with administrative support and/or an executive director

STATISTICS: *Membership numbers from the 2003 CVR survey show:*

- *No limit on membership: 66%*
- *Average size: 50 members*
- *Of those limiting membership:*
  - *53% are LLCs (which are limited if fund)*
  - *20% are informal affiliations (which limit for desired cultural or administrative reasons)*
  - *13% are non-profits*
  - *13% are corporations*

FINANCIAL RESOURCES: FUNDING YOUR ANGEL ORGANIZATION

As with many organizations, funding an angel group adequately can be challenging at best. Asking members for group financial support through dues, a percentage of committed capital, a percentage of the carry, or a combination of these sources is a necessary evil. Rightfully so, members expect value in return, in the form of well-organized meetings, good deal flow, and a satisfying focus on investing.

STATISTICS: *Looking again at the results of the 2003 CVR angel organization survey, we find in response to a question on cost coverage:*

- *67% identified membership dues as one of the primary sources of group funding. Of these groups, 57% identified other sources of funding, including percentage of committed capital (mostly LLCs) and events or sponsorships (mostly nonprofits).*
- *31% listed percentage of committed capital as a source of funding. All but one of these were LLCs, which is logical, since the LLC legal structure predominates angel investment funds.*
- *33% identified sponsorships, with only two organizations listing this as their sole source of financial support.*
- *20% listed events as a source of financing, but none listed events as their sole source. The majority (63%) of organizations listing sponsors and/or events as sources of financing were nonprofit or 501(c) organizations (groups listing both sources were counted only once).*
- *28% indicated that costs were nominal.*

So what are the attributes or parameters of these various funding sources?

- **Membership dues:** If membership dues will be your sole source of funding, they must be set at an amount sufficient to cover all contingent costs and allow for a modest reserve. Annual membership renewal and dues payments will help with budgeting. Also, rather than having rolling renewal dates for members, choose a fiscal-year structure and have annual renewals some time before the start of your next fiscal year. For members joining mid-year, you can offer a percentage discount on dues to encourage membership.

  The "Angel Equity Survey" created and managed by EMME Consulting found, in its Q1 2003 Preliminary Results, a significant variation in membership fees which may be explained by the disparity of services offered by angel groups. This variety of services included:

  - Facilitation (meeting space and administration)
  - Meeting meals
  - Proposal funneling
  - Introduction (introducing entrepreneurs to investors)
  - Proposal screening
  - Due diligence research
  - Standard term sheets
  - Legal services
  - Investment/valuation analysis

- **Percentage of committed capital or pooled funds:**

  - Angel funds in which members are required to commit capital up front typically have a portion of the committed capital allocated to cover operational costs. Along with the 2% to 3% to cover management costs, staff can be compensated and incentived to maximize investment value and return by directing a percentage of the deal (referred to as the "carry") to them. Often staff members are not accredited investors, which can pose a potential problem if the carry is given directly to staff. The discussion under Legal Structure, on limited partnerships, offers one structural alternative to resolve this problem. Your lawyer can recommend other solutions, including a possible LLC.
  - Another form of "percentage of committed capital" is to allocate a portion of the group's specific investment commitment to cover operational costs related to investments. This can be a bit complicated, but arguably fairly allocates expenses. The mechanics would be that after individual members make their contribution to the group investment, but before the actual investment is made, a percentage of the investment amount is carved out to cover the related costs. Problems that can arise from this approach that must be considered include:
    - The possible need for a separate legal entity for each investment, since members will be different for each investment (although some groups already successfully use this model, which will be further discussed under Investment Process).

  - No one invests after expenses are incurred, and they must be covered.
  - Disagreement as to the value and time contributed by staff and, even possibly, other members. This issue is arising with more frequency as member-led groups struggle with how to encourage members to volunteer for the time-consuming task of due diligence. A possible solution is to offer these members some form of compensation. Since cash compensation is usually not appropriate, offering a percentage of the group investment or warrants (if the company is amenable) may be a good solution, but this takes advance planning and group agreement.

- **Sponsorships:** Sponsors can be an effective and significant source of funding, as long as the group ensures that member meetings maintain their focus on member needs. It is important to control the number of sponsors and representatives. The Group Operations section contains suggestions for sponsorship parameters and benefits. Remember, however, that service providers will not generally sponsor an angel organization or any other group/event just to be good citizens. Budgets are often tight, and sponsors need to have some return on their investment for sponsorship dollars.

One caveat: many professionals are also accredited investors and would qualify for membership. An individual's professional background should not prevent membership; otherwise, your membership numbers may be limited. However, all members should understand that meetings are for evaluating investment opportunities and not for selling services. Some groups have gone to the extent to include in their rules of conduct a prohibition against members actively soliciting other members during meetings.

- **Events and programs.** Investment and educational forums can be an effective mechanism for introducing promising new companies and educating the public. Any event is complex and time consuming and should be approached with this recognition. These events are well suited to nonprofit/tax-exempt organizations. For instance, fulfillment of a tax-exempt purpose of education can be met through a variety of vehicles, including a public educational program. Some nonprofit organizations use investment forums as a source of group funding, which can work particularly well in a community with unmet needs for matching investors and entrepreneurs or in which the angel organization has a strong presence to attract investors, presenting companies, and sponsors.

- **Company Fees:** Many organizations charge selected companies for the right to present at a member meeting. Most are willing to pay a reasonable amount for the privilege of exposure to a group of potential investors. However, the amount should not be so large as to drive good companies away or raise possible issues of broker-dealer status for the angel group. Some groups also charge a small amount to all applicants. This amount helps cover the administrative activities associated with processing the application. A slightly higher amount might be supportable for circumstances in which all applications are made available to members through the group Web site, thus increasing company exposure even if not selected for presentation.

SUMMARY OF BUILDING THE FRAMEWORK

We hope that this first part of the Guidebook has given you considerable food for thought and valuable guidance in the establishment of your own angel organization. Although not mentioned before because it seems obvious to the author, do not forget the most important reason for devoting thousands of volunteer hours to creating an angel organization — the journey and resulting successful group are rewarding, personally satisfying, and fun.

As a summary of key points in Building the Famework, the following table offers an alternative view of various choices in the decision process:

TABLE 9:
Creating Your Angel Group Summary

ORGANIZATION TYPE	ORGANIZATION STRUCTURE OPTIONS	GROUP DYNAMICS	ADMINISTRATIVE AND OTHER SUPPORT	MEMBERSHIP REQUIREMENTS
Member-Led Groups	1. Informal organization with little structure: Group of individuals loosely associated under no specific legal structure. 2. Nonprofit corporation/501(c): Members operate under a more traditional corporate structure with a board and officers. 3. Limited liability corporation (LLC): Gives similar advantages and governance options as a traditional corporation, with partnership form of member taxation. 4. Corporation: Traditional structure 5. Limited (liability) partnership: Often related to VC funds	Generally a volunteer organization, with members actively participating on various committees, which can include screening, education, public relations, sponsorship, membership, finance, due diligence, and the board or other governing body, if appropriate. The members are responsible for organizational activities and oversight. Many groups will hire an Executive Director and/or administrative assistant to support the members in functional duties such as meeting coordination, member communication, etc.	Administrative support generally is needed to coordinate multiple logistical activities, including membership lists and mailings, Web site, minutes of committee meetings, membership meetings, coordination of sponsors, recruitment, PR, etc. Sponsorship may also be necessary in order to generate sufficient funds to pay salaries for administrative staff and cover cost of materials, mailings, educational programs, etc.	Sources of financial support will dictate membership dues and the scope of meetings, events, and administration. If the organization chooses to avoid sponsorships but recognizes the need for administrative support, membership dues must be budgeted to cover all anticipated costs plus a cushion. Members typically make their own investment decision, but some organizations have annual investment minimums or form separate investment vehicles, such as LLCs, for pooled investments.

ORGANIZATION TYPE	ORGANIZATION STRUCTURE OPTIONS	GROUP DYNAMICS	ADMINISTRATIVE AND OTHER SUPPORT	MEMBERSHIP REQUIREMENTS
Manager-Led Groups	1. Limited liability corporation 2. Corporation 3. Nonprofit/501(c) organization 4. Limited (liability) partnership All of these types of organizations can have a formalized structure, with management responsible for numerous activities, including screening and evaluating prospective deals, group investments, member communications, etc. The LLC structure is often associated with an angel fund.	Members are involved at various levels depending on their interests, market or industry expertise, and general desire. Members often assist the manager or can lead functional efforts in strategic planning, member relations, or investment identification and selection.	Staff includes a full- or part-time manager, often along with administrative support. An MBA student may also be a member of the staff, often interning through a local MBA program. The manager can often receive part of his or her compensation through a carried interest (the "carry"), thus giving the manager a greater stake in the investment process. Members are assessed an annual fee to cover the manager and administrative costs. The manager and administrative staff can also be compensated through a small percentage of the committed capital (2% –3%), along with a possible carry. Other sources or group financing such as sponsorships can help cover manager costs.	In many manager-led groups, members have capital commitments, with the total amount generally due at two or three closings, depending on the intended length of time for investment. Investing can also be by individual member choice. These organizations sometimes have side funds, which make bridge or complementary investments with members. Investments can be through the angel organization or through separate, deal-specific legal structures such as LLCs. With angel funds, members can usually invest additional amounts on an individual basis into companies the organization chooses to invest in and may also invest outside the organization as an independent investor in non-selected companies.