

## Chapter 3

# Venture Capital Financings of Technology Companies

by

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### § 3:1 Introduction

The venture capital financing of a new technology company is a significant step in its corporate life. To put it simply, “it isn’t just your company any more.”

There are, of course, a number of positives to venture capital financings. A very high proportion of successful technology companies achieved their success in no small part because of the availability of venture capital, which is, in the most commonly accepted definition, capital available for investment in early stage ventures which are, by that very reason, highly risky investments. While the consequences of the investment excesses of the late nineties may have temporarily cast venture capitalists (“VCs”) in a less attractive light, venture capital funds, and the tax and legal infrastructure that have fostered their growth, have been a key engine for growth in the economy of the United States that has been the envy of many other countries and regions.

Not only do VCs provide necessary funding, but they often are helpful to their portfolio companies in a number of other ways. VCs typically have extensive experience with early stage companies. Many have previously been successful entrepreneurs themselves. They contribute this expertise to the founding team and can provide access to a network of management talent, engineers and service providers. They are attuned to the current market parameters for equipment lease and working capital debt financings, the local real estate market and vendor relationships.

VCs are active, not passive, investors. In exchange for their funding and other support, the VCs become actively involved in the management of the business. As discussed in

detail later, the investors typically take one or more seats on the portfolio company's Board of Directors and impose a variety of affirmative and negative covenants on the company.

The real leverage that VCs exert over their portfolio companies, however, derives not from the legal documentation but from the company's need for their ongoing financing support, which as a practical matter must come at least in part from the existing VCs. If the company has fulfilled the VCs' performance expectations, then the need for additional financing is usually not problematic—the VCs will either provide another round of financing themselves or help the company recruit new investors. If, however, the company has not lived up to the performance promises represented by its business plan, the VCs often deal with the company severely—they may provide additional funding, but at a price that results in significant dilution to the existing stockholders—a so-called “down round” financing. Furthermore, there is no practical alternative for the company in this situation—outside VCs rarely, if ever, invest in companies where the existing VCs are not continuing to support the company. In difficult economic times, “down round” financings may occur even though the company has met expectations, due to general market or business cycle disruptions.

One may ask how the emerging technology company can protect itself from this scenario. The answer is at best imperfect, and that is to be sure to raise enough funding in the first round of VC financing to give the company a reasonable chance of achieving demonstrable progress in its business plan. The competing consideration is that companies should not raise more money than is needed in any round of financing because, if the company is performing well, the dilution to the founders is likely to decrease in successive financings at successively higher prices per share.

With respect to the terms of the initial financing itself, companies should attempt to solicit interest from a number of VCs in order to test the general availability of capital and the terms being offered. They should also be extremely protective of their existing cash resources. All leverage is lost if the company becomes desperate for funds. Conversely, there is no better leverage than to subtly let prospective investors know that they are not the only ones interested in investing in the company. On the other hand, this cat and mouse game can be played too vigorously by the prospective

portfolio company, as VCs do not take kindly their deal being “shopped” to other investors.

An alternative is for the company to obtain “seed” financing from so-called “angel” investors. These are wealthy individual investors, frequently successful entrepreneurs themselves (sometimes semi-retired or between active positions), who invest in early stage companies. There are also established networks of this category of investor. Terms from angels typically are more favorable to the company than the terms offered by VCs, and some angel investors intend to become actively involved in their portfolio companies, sometimes even at the operations level. VCs, on the other hand, add the imprimatur of their endorsement of the company and its technology in its dealings with strategic investors, corporate partners and service providers, and typically put more effort into shepherding their investments, but at the level of the Board of Directors. Participation in subsequent financing rounds by angels who invest in an early round should not be presumed. Often the larger capital needs addressed by follow-on rounds are beyond the means of many angel investors, while established VC firms have much deeper pockets and will often reserve funds for their portfolio companies’ subsequent rounds.

### **§ 3:2 Approaching prospective VC investors**

Before even considering the first approach to a VC, the founders need to have prepared a good business plan that addresses all of the important issues that will be of concern to a prospective VC investor.

It is beyond the scope of this Chapter to explore the attributes of business plans that attract funding, but for entrepreneurs that have not “done it before,” good sources of advice on business plans include experienced legal counsel and accounting firms, and a variety of consultants that specialize in the development of business plans and strategic planning. Many VCs will say, though, that it is often a mistake for a business to hire an outsider to write its business plan (as opposed to consulting on refining and improving the company’s best efforts), because a business plan needs to be in the voice of the entrepreneur to adequately convey the message about the business opportunity and the market context in which the company must succeed. There

are also several excellent books on the subject and software products that can assist at least to the extent of providing a structure and methodology for preparing a business plan.

While the entrepreneur should always develop a full business plan, the initial document sent to a VC will generally be a much shorter “executive summary.” The executive summary should be as brief as possible, but must summarize all material information from the full business plan in order to provide prospective investors with enough information to make an initial evaluation.

The first step in planning the approach to VCs is to identify appropriate potential investors. To do so the entrepreneur needs to screen the now quite large universe of VCs for the following factors:

- the firm’s reputation and track record, including the experiences of other successful (and unsuccessful) entrepreneurs
- local offices, although there may be other factors with enough strength to justify looking at firms in other regions
- an investing focus in the company’s vertical space
- an investing focus in portfolio companies at the company’s stage of development
- an interest in deal sizes consistent with the company’s capital needs

Although not a screening factor, the entrepreneur should also know whether the VC prefers to be, or insists on being, the lead investor or will allow another investor to lead.

The outcome of the screening will be a preliminary list of potential investors. This list should then be vetted by the company, its counsel and its other advisors to determine the preferred firms for the initial approach, based on factors including the screening factors, but also on the likelihood of success at getting a meeting. The preliminary list should be pared down to between 5 and 10 VCs to be targetted initially, and if any of the founders or the company’s professional advisors have contacts with the firm, those contacts should be identified.

When the business plan has been completed, the most effective way to get a meeting with a VC is by an introduction (accompanied by delivery of the business plan) by someone

known to and respected by him or her, particularly including successful entrepreneurs funded by the VC in the past and lawyers, bankers, accountants, or other professionals who have been a source of attractive opportunities previously. Once an expression of interest has been elicited, a meeting follows, typically with a single partner of the VC firm. If the partner's key concerns are addressed satisfactorily in that meeting, a meeting with the firm's other partners will follow.

The objective in these meetings is not to close the sale of the company's securities, but to continue to help the potential investors understand the attractiveness of the opportunity and overcome their concerns. This tension between attraction and concern will always be present in the company's discussions with a prospective investor, and the most important job of the entrepreneur is to continue patiently to answer the VCs' questions that are designed to uncover reasons not to invest and to go on to the next opportunity.

At some point in this process, the VCs will conduct background due diligence on the founders and their technology. The due diligence investigation will often include reference checks on the founders, discussions with industry sources, and the assistance of paid outside technical experts in the industry.

Also at some point in this process, the VCs may begin to act and sound more like partners and consultants, rather than inquisitors. This shift in tone can be a signal that an inclination to invest is strengthening.

### § 3:3 The term sheet

Once a VC firm has made a preliminary decision to invest, the company will be presented with a "term sheet," setting forth a statement of the terms of the investment deal being offered to the company and other matters involving the relationship between the company and the VC investors.

Term sheets are generally nonbinding, but sometimes one will see two provisions that are expressly made legally binding. Often there will be a requirement that the company not negotiate with other prospective investors for a period intended to afford a reasonable window of time to either complete the deal or conclude that it should be abandoned. In rare cases, the VCs will require that their expenses be paid by the company if the deal does not close. This provision can usually be resisted successfully.

Term sheets have now become, like the definitive agreements of venture capital deals, standardized documents, using terms that have well understood meaning in the venture capital community but are rarely understood by the first-time entrepreneur. For first-time entrepreneurs, unless company counsel have thought to offer a mini-seminar in advance, the arrival of the initial proposed term sheet often necessitates a crash course in Venture Capital 101. Although most of the legal and business terms contained in the term sheet have become standardized, there are a number of key points that are both important and negotiable. The point to bear in mind is that there are no moral imperatives here—the economic terms of these investments are not inherently good or evil, or fair or unfair. It is a free market, and entrepreneurs are free to accept the terms offered by a prospective investor or reject them. Companies need to first identify from their legal advisers what terms may be negotiable and focus their energy on the possible. The decision to take one VC proposal over another should be based on the valuation offered, the detailed technical terms, the likelihood of the particular investor being helpful to the company in nonmonetary ways, and personal fit (not necessarily in this order).

In general, the term sheet will typically address the following issues:

- the pre-money valuation proposed for the company, the amount the VC proposes to invest, and the percentage of the company they expect for their investment
- the type of security which will be purchased by the VC (virtually always convertible preferred stock in investments by institutional venture capital firms, sometimes convertible notes in seed stage investments by angels) and the terms of the security
- whether and to what extent “vesting” will be imposed on the founders’ shares
- the investors’ rights to have their securities registered for public sale by the company
- whether the investors will have a right of first refusal for subsequent offerings by the company
- rules regarding the composition of the company’s Board of Directors

- the proportion of the company's stock which must be allocated for employees (typically by means of an employee equity incentive plan providing for the award of stock options or the issuance of restricted stock)
- any conditions that must be satisfied before funding will occur, including the somewhat gratuitous observation that the VCs' counsel will conduct a due diligence investigation
- the additional agreements that the VCs will expect to be entered into by the company and the founders

The basic business and legal terms contained in term sheets are discussed in detail in §§ 3:5 to 3:9 below, which also provide some guidance as to the normal give and take on terms and likely outcomes.

### § 3:4 Legal due diligence and corporate clean-up

Once the investors have done their preliminary due diligence and a term sheet has been agreed upon, the lead investor will designate a law firm to serve as investors' counsel. The investors' counsel will usually draft the legal documentation for the transaction. Investors' counsel will also perform "legal due diligence," that is, investigate the company to determine whether it is on sound legal footing and has no identifiable legal risks.

The most important areas of concern for technology company investments include:

(1) whether the company has full rights to the intellectual property that will be used in its contemplated business, including whether the founders have properly assigned any rights they may have to the company, whether all employees and consultants who have contributed to the company's technology have signed acceptable confidentiality and invention assignment agreements, and whether there have been any claims that its products infringe the intellectual property of others or any knowledge of infringement of its intellectual property by others.

(2) whether the founders and key employees are legally free to work for the company and assign to the company their inventions related to the company's business. A related issue is whether there are any potential violations of prior agreements with past employers, such as noncompeti-

tion and nonsolicitation agreements and confidentiality or invention assignment agreements.

(3) whether the company's corporate records are in good order. Critical issues here are whether the company has been duly organized, its outstanding equity securities have been validly issued, and all obligations to issue equity have been disclosed to the investors.

(4) whether there is any litigation, actual or threatened, with respect to the company's products or operations.

(5) whether the company is in breach of any material license or other agreement with vendors, customers, or creditors.

This process is frequently initiated by investors' counsel furnishing to the company and its counsel a legal due diligence request list, outlining various legal and business documents that investors' counsel needs to review. However, a start-up technology company that is represented by counsel who are knowledgeable about the VC investment process can often manage its affairs in a manner that will facilitate the investors' legal due diligence. A typical legal due diligence request list is appended at the end of this Chapter.

### § 3:5 The initial venture financing—Basic terms

The security purchased by investors in virtually all venture capital financings is convertible preferred stock. The terms of this type of stock are discussed in detail below, but the essential elements of convertible preferred stock are: (i) a liquidation preference—the investors have priority over the common stockholders upon a liquidation of the company, which is typically defined to include an acquisition of the company; (ii) a redemption right—at a certain point in time, if the company has not otherwise achieved liquidity for its investors by an initial public offering or sale, the investors may require the company to repurchase their shares; (iii) convertibility—at the option of the investor the convertible preferred stock will be converted into common stock at a ratio that is initially set at one common share for each preferred share, but which is subject to adjustment upon certain dilutive events, including a sale of stock at a price below that paid by the initial investors; and (iv) voting rights on an as-converted basis.

A sample annotated term sheet for a convertible preferred stock financing is appended at the end of this Chapter.

**§ 3:6 —Valuation—Pre-money valuation and the employee pool**

The most important deal term in a venture capital investment is the valuation that the investors put on the company, frequently referred to as the “pre-money valuation.” Essentially, this is the value that the investors place on the company before the financing. The value of the company will be higher immediately after the financing because it will have additional cash—this value is referred to as the “post-money valuation.”

One could logically assume that the price per share paid by the investors would be equal to this value per outstanding share. (If the value of the total enterprise is \$x and there are y shares outstanding, then the value per share of the company would be \$x divided by y shares.) Unfortunately, it is not that simple, and one important surprise for the uninitiated is the methodology by which the venture community calculates the value or price per share of the start-up company. The universal practice is for the total value of the company to be divided not by the currently outstanding shares, but by the “fully diluted” number of shares outstanding, *including* for this purpose the number of shares reserved for an employee stock option pool and any increase to the size of this pool required by the VCs’ term sheet.

This methodology, which has no foundation in the principles of corporate finance or accounting, includes in fully diluted shares outstanding not only stock options and warrants that have actually been issued (as is the case for accounting purposes), but also shares or options that are expected to be issued to future employees of the company in order to fill out its executive, administrative, and technical teams—the so-called “employee pool.” The employee pool is typically 15 percent to 20 percent (but can occasionally be even as high as 30 percent) of the post-money capitalization of the company. In this way, the dilution caused by the issuance of all of the shares reserved for the employee pool is borne by the founders and not by the VC investors.

As a simple example, assume that there are 1,000,000 shares of common stock outstanding and held by the founders, no options have been granted to employees, the pre-money valuation of the company is \$5,000,000, and the VCs plan to invest \$1,000,000. The results with and without

an employee pool are as follows:

<u>Deal Pricing Based on Outstanding Shares:</u>			<u>Fully Diluted Deal Pricing With Employee Pool:</u>		
\$5,000,000 divided by 1,000,000 pre-deal shares equals \$5 per share.			\$5,000,000 divided by 1,300,000 pre-deal shares equals \$3.85 per share.		
VCs' \$1M buys 200,000 shares at \$5/sh.			VCs' \$1M buys 260,000 shares at \$3.85/sh.		
Post-deal capitalization is:			Post-deal capitalization is:		
<u>Stockholder</u>	<u>No. of Shs.</u>	<u>Percent</u>	<u>Stockholder</u>	<u>No. of Shs.</u>	<u>Percent</u>
Founders	1,000,000	83%	Founders	1,000,000	64%
Investors	200,000	17%	Employee Pool	300,000	19%
	1,200,000	100%	Investors	260,000	17%
				1,560,000	100%

A common instinct of founders is to be generous to the employees and make the pool as large as possible. Oddly, this may be against the founders' interests. At least in theory, it is in the interest of the stockholders of the company that the Board of Directors grant stock options to employees as an incentive to attract and retain the best possible talent—but not one option more than necessary. It is in everyone's interest, VCs and founders alike, to do so, and it is therefore likely, regardless of the pricing methodology of the deal, that the VCs will grant any waivers necessary to attract this talent. Thus, starting out with a smaller pool will result in less dilution to the founders, since post-deal expansions of the option pool dilute the founders and the VCs proportionately.

Logical or not, the employee pool is a fixture of the venture financing. The actual size of the pool can depend on a number of things, including the industry that the company is in, but is primarily related to the number and types of hires which the company will need to make in the foreseeable future. Thus, a company which has a complete management team at the time of the initial convertible preferred round will usually have a smaller pool than a company which still needs to make one or more top management hires (each of whom may cost the company a significant amount of options or stock from the pool, depending on the current market for such talent).

In analyzing the best economic deal for the founders, the

price per share (a function of valuation and the fully diluted capitalization) is the most critical issue. It will dictate the percentage of the company that the VCs acquire for a given amount of investment.

### § 3:7 —Board composition post-deal

One of the critical negotiating points in a VC financing is the structure of the Board of Directors and the related issue of control of the company after the deal is concluded. This is often a very sensitive issue for all parties. Majority control of the Board of Directors effectively constitutes control of the company. The company and its officers legally must follow the Board's direction, including the hiring and firing of personnel (founders included). This is, in part, what we meant at the outset in saying that "it isn't just your company any more." Under certain circumstances, the founders can—and sometimes do—find themselves dismissed from their "own" company.

Founders are often inclined to try to maintain majority control of the Board, and VCs tend to see this as a red flag. The founders' typical position is that it is their company, so they do not want outside investors to control it. The VC response (at least where they are purchasing a significant share of the company—30 to 50 percent, for example) is that they are unwilling to invest in a company that is controlled by the founders. In the large majority of cases, neither the founders nor the VCs wind up with a Board majority. The solution is typically a compromise—the investors are entitled to nominate an equal number of directors with the founders, and those directors will jointly select one or more independent directors, ideally with relevant industry or entrepreneurial experience. In this manner control is shared through a rough balance of power on the Board. The founders are still at risk of being put out of their "own" company, but the independent Board members will need to be convinced that such an action is in the best interest of the company. There is strong logic to the argument that, if they can be so convinced, it is a fair result for all of the stakeholders in the company. (The only consistent exception to the foregoing scenario is the relatively rare case in which the VCs are purchasing a small minority share of the company, for example, 10 to 15 percent, where they will normally be willing to accept one board seat out of three or five.)

Because the founders will be working extremely closely with the Board members nominated by their venture backers, the founders should attempt to get an informal commitment from the VCs as to the identity of their Board nominees. Typically, this is the senior venture investor who negotiated the deal, but that is not always the case. Junior staff will sometimes serve that role, particularly in busy times. The founders want to be sure that they are getting what they bargained for—the wisdom, experience, and assistance of senior venture investors. Most importantly, founders should not simply assume that the “sponsor” of the company at the VC fund will end up being that fund’s designee on the Board.

Under the corporate laws of Delaware and most other states, a majority-in-interest of the stockholders can elect the Board of Directors. Given the artificially arranged balance of Board seats described above, this would not be a desirable outcome. The mechanism that is used to override these default provisions of the law is a voting agreement, in which the allocation of Board seats is specified and all parties to the agreement (who must comprise, and continue to comprise, the holders of a majority of the voting stock) agree to vote their shares and take any other actions necessary to elect the nominees of the respective groups, that is, both the founders and the investors. The same scheme applies to removals of directors and the filling of vacancies.

There is little to be negotiated in a voting agreement once the Board composition is agreed upon. However, care must be taken to ensure that the agreement expires upon an initial public offering or an acquisition of the company. These arrangements have no place in a public company, and an acquiror will want to completely control the company that it just bought.

An alternative technique that is sometimes employed to effect the desired Board split is to amend the company’s certificate of incorporation (while it is being amended to create the convertible preferred stock that is being issued in the deal) to specify that the preferred stockholders are entitled as a class to appoint the agreed-upon number of directors. This approach is not really necessary and has undesirable consequences. Voting agreements are enforceable, and the investment documents for the deal will always specify that the nominees of the VC investors be elected to the Board effective at the closing. “Baking into” the charter such provi-

sions only makes the arrangement unduly rigid and inconvenient to change. The voting agreement/condition to closing approach is legally and practically sufficient to ensure the proper Board split.

**§ 3:8 —Founder and employee equity compensation and vesting**

Another extremely important negotiable term in venture deals is whether, at what rate, and under what circumstances the common stock or stock options already issued to the founders will be subject to so-called “vesting.” It should be assumed that any stock or options held by employees, including founders, will be subject to a vesting schedule following the VC investment, whether or not the founders have imposed a vesting schedule on themselves.

“Vesting” is a shorthand term referring to the vesting of the ownership interest of an employee stockholder or option holder in the stock or options over the course of his or her employment with the company. It is a generally accepted notion that, upon termination of employment of an employee, the company will have the right to buy back a percentage of the employee’s shares at the price paid for them, or in the case of options, that the employee’s right to exercise a percentage of the options will lapse. The percentage of shares which may be repurchased at cost, or of options which lapse, decreases over the employee’s tenure with the company.

The idea that the vesting concept might retroactively be applied to stock owned outright by founders since the company’s organization is not intuitively obvious to many founders, but vesting provisions are almost universally imposed on founders as part of an initial VC financing. This is the origin of the term “sweat equity.” The rationale is that the founders must “earn out” their shares by their continued contributions to the company. If a founder’s contributions cease, it is thought only fair that some portion of that founder’s equity be forfeited and made available to the successor who must be hired to perform the terminated founder’s function at the company. Implicit in this view is the assumption that the founders did not pay true “fair value” for their shares but effectively were allowed to buy “cheap stock” (typically at par or nominal value) because they will not be paid market-rate cash compensation for their services.

(Where founders invest their own funds in a venture round, they are treated identically to the other investors with respect to the stock so purchased.)

As a side note, it is almost always advisable for the founders to impose vesting restrictions on themselves when they initially organize the company, and experienced counsel will advise them to do so. One reason flows from the fact that vesting is a virtually universal feature of venture financings: if the founders have already put in place a vesting scheme that is reasonable and within the normal range for the industry, the VCs may leave this scheme in place and not impose their own. The other reason to do so is that it is fair and makes business sense: the founders receive their founders' stock not only for their role in conceiving the ideas and business plan for the company, but, as stated above, for their continuing efforts on the company's behalf. They view each other as making a commitment to continue their contributions during some period that is thought to be reasonably necessary to ensure the company's success. To illustrate the point another way, if each of three equal founders receive an equal number of shares upon the organization of the company, few would regard it as fair if one founder quit the next day and kept all of his or her shares.

Whether there will be vesting is rarely negotiable. The precise terms and conditions of vesting *are* negotiable. Those terms and conditions are typically set forth in the proposed term sheet from the VCs and will be documented in an agreement between the founders and the company called a stock restriction agreement.

Conceptually, vesting provisions should be tied to the expected performance of the founder over a period of three or four years after the organization of the company. Looking at it this way, the founders should attempt to agree among themselves what these contributions are expected to be over the specified period of time. So, in the usual case, the founders will make a certain contribution to the company at the outset—it is their novel ideas that form the basis of the company. If the founders, for example, agree that these ideas fairly represent 20 percent of the anticipated aggregate contribution, then the founders should be 20 percent vested from the outset, or “up front.” The vesting would continue over the remaining period of their expected contribution. Where the founders have made significant progress in

developing products or intellectual property or in achieving sales, a common range of vesting provisions would be 20 percent to 30 percent up front, with the balance vesting over three or four years (the founders typically choosing three years, and the VCs normally looking for four-year vesting). If all the founders have accomplished is writing the business plan, there may be no up-front vesting.

Vesting increments can occur annually, quarterly, monthly, or daily. Generally, a relatively frequent vesting interval is considered preferable, both for the company and the employee. From the company's perspective, it is undesirable to have an employee who has decided to leave hanging around for the next tranche of his or her vesting, and employees tend to assume the worst motives when a termination occurs shortly before a vesting date. Annual vesting periods magnify both concerns, while the amount at stake in a monthly vesting scheme is less significant and therefore less likely to control termination decisions. (A very few companies even opt for daily vesting on the theory that they do not want employees "treading water" until the next vesting date.) Perhaps the most common scheme for new hires is to have the first vesting installment occur after one year of continuous employment at the company, with the balance vesting monthly or quarterly over two or three additional years. This permits the company to evaluate and, if necessary, terminate new employees during the first year of employment, before they become entitled to any equity. Founders, on the other hand, should seek monthly or quarterly vesting from the beginning.

The percentage of up-front vesting and the vesting period are not the only issues that must be dealt with. Founders may be successful in negotiating for a partial or full acceleration of vesting upon an acquisition of the company (or, rarely, upon an IPO). This is a provision that has important employee morale implications, as well as being a potential impediment to an acquisition. There are again competing considerations regarding acceleration clauses. With respect to acquisitions, from the company's and a potential acquiror's point of view, no acceleration is best because what the acquiror is paying for in a technology acquisition is, in part, the expected continuing contribution of the company's employees, particularly the technical employees. The acquiror wants them to have an incentive to continue working and

does not want them to get so rich as to lose the incentive to continue to work. The competing viewpoint is that the employees have “earned” something from the VCs and other stockholders by “delivering” an acquisition and allowing the VCs to realize value. They question why the VCs should be able to cash out while the employees are required to continue to earn out their equity. In any event, some amount of acceleration probably is representative of the market, at least for senior management and maybe even deeper into larger businesses.

The most common solution, at least for senior management and other key personnel, is a compromise between no acceleration and full acceleration of vesting—that is, partial acceleration upon an acquisition. Some percentage of the vesting is accelerated on an acquisition, with the balance continuing to vest, perhaps at an accelerated rate or with a shortened full vesting date *provided* the employee remains employed by the acquiror. A fixed number of options can vest; a percentage of the unvested options can vest; or a specified additional vesting period can be deemed to have elapsed. There are subtle differences between these alternatives. If the first or the second approach is used, a reduced vesting rate would be specified for the balance so as to continue the existing vesting schedule. If a deemed time lapse is used, the agreement should expressly provide for clarity that all remaining vesting dates are similarly accelerated.

Frequently, the employee is also relieved from the threat of loss of unvested equity if terminated without cause following an acquisition—in that event there is full vesting. Some argue that if the employee is never offered a job with the survivor/acquiror, then there should be full acceleration of vesting, either on general fairness principles or because the acquiror shouldn't care—if the employee is not wanted, then incentives aren't needed to keep him/her on board. The problem with this approach is that employees who are not hired are treated better than those who are hired—an oddity with potential unwanted consequences. Further, the survivor/acquiror will argue that the employee not hired is in effect being terminated, and that he or she is only entitled to the vesting that has occurred prior to the date of such termination, like any other employee who is terminated without cause. Another approach is to provide for full vest-

ing after a transition period—say six months or one year following the acquisition.

One further subtlety is that experienced VCs will sometimes define an acquisition for acceleration purposes so that it includes only an acquisition where the consideration is cash or publicly traded stock or a combination. The thinking here is that the founders have not really delivered a liquidity event for the VCs if the company is acquired by another private company, particularly if both companies are troubled.

Considerations similar to those of acquisitions theoretically would apply to IPOs. The prevailing practice, however, is not to have acceleration clauses in this case. Presumably, the controlling rationale is the possible loss of key employees which may result from the acceleration and the related concerns that would result from disclosure in the IPO prospectus.

Founders may sometimes be successful in negotiating more favorable treatment in the event they are terminated by the company without cause or quit “for good reason,” as opposed to voluntary departure (that is, quitting without good reason) or termination by the company for cause. The advisability of this approach is subject to continuing debate among lawyers specializing in representing start-ups and in venture capital financings. On the one hand, it can be argued that a less harsh result is appropriate if a founder is terminated without cause or leaves because the company has failed to keep its obligations to him or her. The answering argument is that young companies do not want to be in the position of having to debate (or worse, litigate) whether a termination is with or without cause or for good reason, and because termination of a founder for failure in performance deprives the company of the benefit of its bargain in negotiating the founders’ equity position in the first place—and a substitute must be found and compensated in any event, termination of a founder therefore should result in full forfeiture of unvested shares. Both points of view are legitimate, but the latter approach usually prevails in the negotiations.

Frequently the repurchase right for unvested shares is phrased as an option on the part of the company to repurchase the departing founder’s shares for a specified period of time, typically 30 to 90 days. A better practice may be to make this a fixed obligation of both parties. The circumstances under which a company will not want to repurchase

shares at par or nominal value are rare, and an automatic repurchase provision avoids a trap for the unwary that offers no offsetting advantages: the possibility of failure to timely exercise the repurchase option because of an administrative oversight.

Inexperienced counsel or entrepreneurs will often impose an additional restriction on the vested shares, permitting them to be repurchased by the company at fair market value (usually as determined by the Board of Directors) upon termination of employment. Under this scheme the odds of one side or the other being unfairly treated are about 100 percent, and the odds of litigation are needlessly multiplied. The reason is that early stage technology companies are inherently difficult to value. There is really no adequate methodology. The proof is in the pudding—the only real way to determine what a company is worth is to sell it or take it public. In a private technology company, repurchases at “fair market value” simply don’t work well.

### § 3:9 —Section 83(b)

Whenever a company issues stock to an employee that is subject to a repurchase option of the company, the employee should seek advice from his or her tax advisors regarding the relative benefits of filing or not filing an election under Section 83(b) of the Internal Revenue Code. Under Section 83 of the Code, an employee will recognize income in respect of property (including stock) received in connection with the performance of services; the amount of income is the difference between the value of the stock at the time he or she receives it and the amount he or she pays for it. However, where the stock is subject to restrictions which lapse over time, such as a repurchase option which lapses pursuant to a vesting schedule, the employee will recognize compensation (that is, ordinary) income at the time or times the restrictions lapse, again in an amount equal to the difference between the value of the stock at the time the restrictions lapse and the amount paid. Thus, an employee who is issued stock during the start-up phase of a company that becomes successful, and whose stock is subject to vesting provisions over a period of years, will become taxable, at ordinary income rates, on the excess of the sometimes vastly appreciated value of the stock over what was paid for it as the company’s repurchase rights lapse.

If the employee believes that the value of the stock is likely to appreciate (that is, the company is likely to be successful) and that the shares are likely to vest, a Section 83(b) election can provide significant tax benefit. If the employee makes a Section 83(b) election, his or her receipt of the stock is the relevant tax event, and he or she is taxed at ordinary income rates on any excess of the value of the stock when received (without regard to the vesting provisions) over the amount paid for the stock. If the initial purchase price of the stock is equal to the fair market value, then the election results in no tax liability. More importantly, as a result of making the Section 83(b) election, the employee will recognize no income upon vesting, and if the employee vests, he or she will report capital gain (rather than ordinary income) upon selling the stock in an amount equal to the amount received in the sale over the amount paid for the stock.

Section 83 considerations may also apply in situations in which a founder or key employee purchases (or is granted) stock outright and then at a later date agrees to the imposition of vesting restrictions in connection with a venture capital financing, or in which stock acquired upon exercise of an option is itself subject to a repurchase option.

Section 83(b) elections must be filed within 30 days after the date on which the restricted stock is acquired. An inadvertent failure to file the election is a trap for the unwary with potentially very substantial tax consequences.

### **§ 3:10 Form of security—The ubiquitous convertible preferred stock**

The virtually universal structure for a VC investment is convertible preferred stock. Because it is convertible into common stock at the option of the holder, convertible preferred stock entitles the VC investors to their full upside win if the company is successful, and it entitles the investors to the return of their investment before the founders if the company fails. Convertible preferred stock also permits various other protections for the investors that are discussed below—voting rights, antidilution provisions, various approval rights, and redemption provisions.

An exception to this structure is sometimes used for early stage companies where it is too difficult for the investors and the company to arrive at an agreed valuation—the investors

have made a determination that the company is worth investing in, but they are unable to satisfy themselves (or can't agree with the founders) at what price. A related exception is for the more seasoned company where valuation is difficult because of turbulent private equity markets, or where a bridge loan is being extended to an existing portfolio company in anticipation of an impending next round, and a valuation decision is to be avoided because it will be independently set in negotiations with new VC investors in the upcoming round. In these cases, the investors and the company may defer the valuation decision by structuring the investment in the form of a promissory note that is automatically converted into the next round of preferred stock financing either at the price of such round or at a discount thereto, or if such a round does not occur within a specified time frame then at a specified (usually low) valuation. These transactions are relatively quick and inexpensive to implement.

### § 3:11 —Liquidation preference

The first important economic aspect of convertible preferred stock is its liquidation preference. The common theme in various types of convertible preferred stock investments might be dubbed "heads I win, tails you lose." In so-called "straight convertible preferred," upon a liquidation of the company, the investors are entitled to whichever of two options results in the greater return: (i) the amount they paid for the stock, usually with an accruing dividend of 7 to 10 percent or more on that amount, paid upon redemption of their preferred shares; or (ii) the amount distributable to the common stockholders, payable to the former preferred stockholders after conversion of their preferred shares to common stock. (It is important, when representing the VC, to phrase the clause as the investors' being entitled to receive whichever of clause (i) or (ii) ultimately turns out to be the greater, rather than requiring the investors to make an election up front, because in some scenarios, particularly earnout transactions, it is impossible to tell at the time of the "liquidation" whether the preferred holders are better off taking their liquidation preference or converting to common. Only later, when the amount of the earnout has been determined, is it possible to make that assessment).

In another variation of convertible preferred stock called

“participating preferred” (or more pejoratively, “double dip preferred”), the investors are first entitled to receive their liquidation preference (price paid plus accrued dividends, or in some cases a multiple thereof), and then, *after* they have received their liquidation preference, their preferred shares are deemed to have converted into common stock so that they share *pro rata* in the remaining proceeds with the common stockholders. This structure economically mirrors a note-and-warrant or note-and-common-stock structure, without the adverse credit consequences of debt in the capital structure.

In difficult economic times, VC investors may also require that the liquidation preferences be tied to a multiple of the amount paid per share. With such a preference, the investors are entitled to be paid, for example, five times their original investment before the common stockholders get anything. Many commentators have questioned the wisdom of this practice, even from the investors’ point of view, because of the severely negative effect on the chances of management and key employees realizing a return on their investment. The result may be that founders and employees will “vote with their feet” and leave for better opportunities elsewhere.

The choice of one type of liquidation preference over another is simply a matter of negotiation. Neither is inherently good or evil, fair or unfair. All things being equal, participating preferred effectively puts a lower valuation on the company. Obviously, the entrepreneur should try to negotiate for straight convertible preferred stock rather than participating preferred. If the founders receive offers with both structures, they simply need to compare the economics under various win scenarios to see which is more favorable. The higher the multiple of the price paid by the investors that is received in an acquisition of the company, the less significant is the participating preferred feature as an economic matter. Founders frequently can negotiate a cap on the participating preferred feature. With a cap, the formulation would be that the investors receive the greater of (i) the liquidation preference plus their share of the remaining proceeds, but only up to a specified multiple of the original investment, typically three to five times, or (ii) the amount the investors would have received if they had converted to common stock immediately before the liquidation.

In either of these formulations, the term “liquidation” is defined to include an acquisition of the company. Until recently, there never were any real liquidations of VC-backed companies where proceeds were available to the equity holders. An acquisition is typically defined to include mergers where the stockholders of the target in their capacity as such no longer own a majority of the equity securities and/or voting power of the surviving corporation or its parent, or a sale of substantially all of the outstanding capital stock of the company, or a sale of all or substantially all assets.

### § 3:12 —Dividends

The convertible preferred stock terms in VC transactions do not affirmatively require payment of dividends on the preferred stock, except in the situations described below. Rather, they prohibit payment of dividends on the common stock, and they typically include a “cumulative” dividend on the preferred (often 7 percent to 10 percent or more per annum). This dividend “accrues” (or “cumulates”) and is not payable unless (i) declared by the Board (which it never is because it would be hard to justify a dividend given the growth company’s need for cash and given that the VCs typically don’t control the Board); (ii) there is a liquidation event (a sale of the company is considered a liquidation event, but an IPO usually isn’t); or (iii) the preferred stock is redeemed. The accruing dividend is a protective device intended to provide a minimum rate of return, but it is usually forfeited in the event of an IPO or upon conversion of the preferred stock to common stock (the theory being that in such cases the return on the investment will be more than the minimum which the accruing dividend provides; therefore, the protection is not needed and is forfeited). There are a number of varieties of accruing dividends, including those that are payable in cash and those payable in additional shares of preferred stock. Also, although a basic “accruing dividend” involves a simple interest calculation, sometimes VCs require compound interest calculations.

**§ 3:13 —Antidilution provisions**

Antidilution provisions are potentially the most threatening to founders of all the aspects of convertible preferred stock. The ratio that is used to calculate the common stock issuable upon conversion is variable, with potentially severe adverse effects on the founders and other common stockholders.

Antidilution provisions are of two types and accomplish two basic objectives, one entirely noncontroversial and the other potentially highly controversial.

The noncontroversial antidilution clauses are those that automatically adjust the conversion price (see below) in the event of stock splits, stock dividends, recapitalizations, and similar events. These are essentially corporate housekeeping provisions, but are nonetheless necessary because of the risk of injudicious case law that may not protect the investors in such situations.

The other form of antidilution protection insisted upon by VCs is price antidilution. To understand how antidilution provisions work, first one must understand that, when the preferred stock is initially issued, the conversion ratio of preferred into common is set at one-for-one. The formula to determine the ratio is the original issue price of the preferred divided by the “conversion price,” which originally is the price paid so as to achieve the one-to-one ratio. When a subsequent round of financing is done, it is to be hoped that the price for the securities issued will be higher, which it will be (market conditions and all other things being equal) if the company is succeeding. The price could also, however, be the same or lower. If the price is the same or higher, the antidilution provisions do not come into play. It is only if the price in the subsequent financing is lower that the antidilution provisions operate to lower the conversion price so as to give the preferred stockholders a higher number of common shares upon conversion, on the rationale that this compensates them for the equity dilution suffered when the later investors buy stock for a lower price per share.

There are two basic types of price antidilution protection, “weighted average” and “full ratchet” (or “ratchet”). Weighted average antidilution mitigates the impact of the antidilution adjustment. Put simply, weighted average antidilution protection accounts more accurately than does

full ratchet antidilution for the actual dilutive effect which a particular issuance has on the investors' equity position in the company: a more significant adjustment in the conversion ratio of the preferred stock if a larger number of shares of stock is issued at a lower price, and a less significant adjustment if a smaller number of shares is issued at a lower price. With weighted average antidilution, upon a sale of stock at a price lower than the conversion price, the conversion price is lowered to a price that is an average of the price at which the company has sold stock, valuing the common stock outstanding at the pre-adjusted conversion price. An issuance of warrants, stock options, or convertible securities is deemed to be a sale of the underlying stock. (There is a continuum of weighted average formulas, from broad-based to narrow-based, the variation being in which common stock equivalents are included in the fully diluted base over which the dilutive effect is spread.)

The harsher form, full ratchet antidilution, on the other hand, treats all later stock issuances below the investor's purchase price as if they were the same, resulting in the same adjustment to the conversion ratio regardless of the number of shares issued. The conversion price is "ratcheted" down to the lowest price at which stock is sold after the issuance of the convertible preferred, even if only one share is sold at that price. Thus, if the next round of financing is for a price that is half of the first round price, the conversion price of the original preferred will be cut in half so that the original preferred investors will receive twice as many common shares upon conversion, all for no additional consideration, resulting in significant dilution to the founders and other common stockholders. In this way, the original preferred investors are effectively—retroactively—given the lowest price at which the company's stock is sold.

A representative weighted average antidilution clause reads as follows:

In the event the Corporation shall at any time after the Series A Original Issue Date issue Additional Shares of Common Stock, without consideration or for a consideration per share less than the applicable Conversion Price in effect immediately prior to such issue, then and in such event, such applicable Conversion Price shall be reduced, concurrently with such issue, to a price (calculated to the nearest cent) determined by the following formula:

$$p = \frac{p^1 q^1 + p^2 q^2}{q^1 + q^2}$$

where:

- p = Applicable Conversion Price following new issuance  
 p<sup>1</sup> = Applicable Conversion Price prior to new issuance  
 q<sup>1</sup> = Number of shares of Common Stock outstanding prior to new issuance before  
 [or may be shares outstanding on a fully diluted basis – so-called “broad  
 based” formula antidilution]  
 p<sup>2</sup> = Price per share of new issue  
 q<sup>2</sup> = Number of Additional Shares of Common Stock issued in new issue

There are a number of customary exceptions to the operation of the ratchet or weighted average formula antidilution clauses. The following is sample exclusionary language listing issuances of stock or options where no antidilution adjustment is permitted:

“Additional Shares of Common Stock” shall mean all shares of Common Stock issued by the Corporation after the Series A Original Issue Date, other than:

- (i) shares of Common Stock issued or issuable upon exercise of any Options outstanding on the Series A Original Issue Date or conversion or exchange of any Convertible Securities;
- (ii) shares of Common Stock issued or issuable as a dividend or distribution on Preferred Stock;
- (iii) shares of Common Stock issued or issuable by reason of a dividend, stock split, split-up, or other distribution on shares of Common Stock that is covered by Section [●] or [●] below;
- (iv) up to [—] shares of Common Stock (or such greater number as is approved by a majority of the Board of Directors, including directors nominated by the holders of the Preferred Stock) (or Options with respect thereto) (subject in either case to appropriate adjustment in the event of any stock dividend, stock split, combination, or other

similar recapitalization affecting such shares), previously issued or issuable in the future to employees or directors of, or consultants or advisors to, the Corporation or a subsidiary pursuant to a plan or arrangement approved by the Board of Directors of the Corporation (provided that any Options for such shares that expire or terminate unexercised, or shares issued thereunder that are repurchased at cost pursuant to the terms thereof, shall not be counted toward such maximum number); or

- (v) shares of capital stock, or options or warrants exercisable therefor, issued to banks, vendors, or equipment leasing organizations in connection with bank financing, vendor relationships, or equipment leasing arrangements to which the Corporation is a party, or shares of capital stock issued in connection with the acquisition of another business, in each case which has been approved by a majority of the members of the Board of Directors.

While it is beyond the scope of this Chapter to discuss in detail the issues of down-round financings, any discussion of price antidilution protection, particularly in the post-Internet bubble venture capital climate, should mention a device sometimes proposed by companies to protect against earlier investors getting the benefits of full ratchet antidilution without even providing more capital to the company. So-called “play-or-pay” provisions provide a strong incentive for existing investors to participate in subsequent rounds. If a preferred investor subject to a play-or-pay provision does not participate in a new round of financing, some or all of the privileges (for example, the price antidilution protection, liquidation preferences, special voting rights, or redemption rights) attached to the investor’s preferred stock are stripped, usually by automatic conversion into a series of preferred stock without those privileges or by outright conversion into common stock. Play-or-pay provisions are often heatedly argued among different investor groups.

**§ 3:14 —Mandatory conversion into common stock**

Convertible preferred stock terms provide that upon the effectiveness of a registration statement under the Securities

Act of 1933 covering a firm commitment underwritten public offering of common stock of the company by a nationally recognized underwriter, the preferred stock automatically converts into common stock immediately prior to the IPO closing. The reason for this is that the prospect of continued existence of the convertible preferred after the IPO would adversely affect the marketing and pricing of the IPO itself, and many of the terms and provisions of venture capital preferred stock are inconsistent with the operation of a public company.

In addition to the firm commitment underwriting requirement, the public offering price is usually required to be at least a specified multiple of the conversion price with specified aggregate gross proceeds received by the Company from the IPO. These additional requirements are probably unnecessary as a practical matter and can be problematic in some circumstances. One would find it hard to imagine an IPO by a nationally recognized underwriter that would not be welcomed by the venture investors. Where the additional requirements are not quite met, the last minute scurrying around to get the necessary waivers can be an impediment to getting the IPO priced and closed on time. Counsel who are experienced at doing IPOs will try to persuade the venture investors to eliminate these extra requirements from the outset.

### **§ 3:15 —Covenants and separate voting rights of the preferred**

Because the investors do not have majority control of the Board of Directors, they believe it is necessary to have veto rights over certain major corporate actions. A typical list of the actions that the company will be prohibited from taking without the consent of a specified percentage of the preferred is set forth in the following sample language:

Without the consent of a specified percentage of the preferred, the Company will not:

(i) amend or repeal any provision of, or add any provision to, the Company's By-laws if such action would adversely affect the preferences, rights, privileges, or powers of or the restrictions provided for the benefit of the Preferred Stock;

(ii) pay or declare any dividend or distribution on any

shares of its capital stock (except dividends payable solely in shares of Common Stock), or apply any of its assets to the redemption, retirement, purchase, or acquisition, directly or indirectly, through subsidiaries or otherwise, of any shares of its capital stock (other than repurchase of Common Stock at cost upon termination of employment or service);

(iii) reclassify any Common Stock into shares having any preference or priority as to assets superior to or on a parity with any such preference or priority of the Preferred Stock;

(iv) sell, lease, or otherwise dispose of all or substantially all of its assets, or properties;

(v) voluntarily liquidate or dissolve;

(vi) acquire all or substantially all of the properties, assets or capital stock of any other corporation or entity;

(vii) enter into any merger or consolidation, or permit any subsidiary to enter into any merger or consolidation; or

(viii) incur indebtedness for borrowed funds in excess of \$[\_\_\_\_\_] in aggregate principal amount any time outstanding.

The choice of the requisite approval percentage requires care. Often the investors will be more concerned about being able to block a transaction that they don't like and will set the approval percentage quite high. Founders should try to convince the investors that this approach is not in their own interest—the risk of a group of investors *not* being able to do a deal they want to do because of an unreasonable investor is greater than the risk of not being able to block a transaction that the group does not want to do.

### § 3:16 —Redemption

Convertible preferred stock issued in a venture capital financing typically has a redemption feature. In the event the company has not been acquired or gone public within a specified period of time, then a specified percentage of the preferred holders can require the company to redeem their preferred stock at the liquidation preference amount. The payout of the redemption price is usually spread out over several years. The purpose of this clause is to give the VCs

control over a situation where the company no longer appears to be on a growth company track, but is instead “going sideways.” Because venture capital funds have limited lives, there is some pressure on the VCs to liquidate their investments within a fixed period of time—hence the redemption feature.

The actual use of the redemption feature is rare. It is the rare growth company that has the legally available capital to finance a buyout. So the “threat” represented by these clauses is largely illusory. Unless the company has sufficient legal capital under the applicable business corporation statute, the company will be prohibited from redeeming the preferred. To put some teeth into this clause, investors may demand a clause providing that, if there is a default, the investors will get the right to control the Board. This is rarely done, in part because, out of concern for creditors’ rights and similar laws, investors are reluctant to take control over the Board in those circumstances. Indeed, in the roaring nineties, redemption clauses were frequently omitted from preferred stock terms.

Redemption features are usually phrased in terms of what is, in effect, a put right, rather than an automatic redemption. The reason for this approach is that in a sideways-but-slightly-up scenario, where the company is worth more per preferred share than the redemption price, the investors don’t want to be limited to a redemption at a fixed price or worse, an automatic redemption feature. An increasingly common feature is for investors to have a put right at the *higher* of the liquidation preference or fair market value as determined by an agreed valuation procedure.

In sum, redemption features are probably not worth the legal expense that it takes to create them, but are nonetheless standard features of VC financings.

### § 3:17 —Ancillary agreements

In a typical venture capital closing (see the sample closing agenda for a convertible preferred stock VC financing appended at the end of this Chapter), there are a number of customary agreements that are executed implementing a fairly standard suite of other business and legal terms.

— Stock Purchase Agreement. This is the agreement pursuant to which the investors agree to make their invest-

ment in the company. It is much like any other purchase agreement. The purchase price of the preferred investment is specified, and there are conventional representations and warranties of the company, investment representations of the investors that are necessary to comply with securities law private placement requirements, affirmative and negative covenants, and conditions to closing. The most contentious issues with the Stock Purchase Agreement are whether or not the founders are required to make separate representations, and whether or not there will be a single funding or staged fundings based on the satisfaction of performance or other conditions.

As for personal representations by the founders, in a first-round financing, this practice is not unusual. In a sense, for the company alone to make the representations is meaningless. If there later turns out to be a problem with a representation, it will be impossible to make the investors whole since the only cash invested in the company is theirs, some or all of which may have already been spent. The investor therefore would only be entitled to get a portion of their investment back if there were a misrepresentation. The approach to this problem of various VC firms and their counsel varies widely. At the extreme, the founders are asked to jointly make the same representations and warranties as the company, including such things as due organization of the company, valid issuance of its stock, and non-contravention of rights of, or agreements with, others. This is usually strongly resisted by the founders and company counsel. A more balanced and fair approach is to ask the founders only to represent to those things that they should know about—that there are no promises to issue equity other than as disclosed, that the founders themselves are not in violation of previous employment, inventions, confidentiality, and noncompetition agreements, and that they have no actual knowledge of any threats related to any of the foregoing or to intellectual property matters. In subsequent financing rounds, after the company has been up and running for a reasonable period of time, founder representations are relatively rare.

Whether there is one or multiple fundings significantly affects the economics of the deal. At times, investors require that the obligation to advance the committed funds

be staged over several closings. Whether the availability of funds is immediate or over a period of time is not the important issue. The real issue is on what terms the investors will be excused from advancing the additional funds. Sometimes the condition to the second closing is only a reaffirmation of the representations and warranties, including that there has been no material adverse change in the business. If there is such a condition, care must be taken in the phrasing of the representations and warranties. For example, if the company has represented that a specific number of shares are outstanding, then that representation should only need to remain correct as of the date it was first made. Otherwise, the mere issuance of additional stock will constitute a breach of that representation and a failure of that condition to the subsequent closing. Usually, there is also some variation of a “bring down” of the no-material-adverse-change representation. The investors argue that it is not possible to adequately cover all the events for which they need protection in the more specific representations and warranties. From the company’s point of view, this representation is inherently vague and subject to dispute. The company would also argue that the risk of an adverse change is one that the investors should be considered to have accepted in a high risk technology company and should not be an excuse for them to abandon the company.

Similarly, at times conditions to subsequent closings are imposed requiring the company to meet certain performance milestones. The investors argue that they are investing based on management’s assurances as to the achievement of the specified milestones within a certain time frame. In effect, the investors are saying that they want to put their money where the company’s mouth is. The company is in a difficult position to argue in some cases. The more nervous management appears about the milestones, the more they risk losing the investors. In any event, the company needs to be very careful that it receives enough funding at the first closing to achieve the milestones it is required to achieve before additional funds are advanced.

— Right of First Refusal and Co-Sale Agreement. In a private company both the founders and the investors have a common interest in preserving the integrity of the inves-

tor, employee, and founder group's ownership of the equity of the company. The founders, and sometimes the investors, are prohibited from selling their shares to a new investor without giving—first to the company, and then to the investors (and sometimes the founders)—a right of first refusal to purchase the securities available for sale at the price that has been offered. Typically a further requirement is imposed on the founders (but almost never on the investors) that if the first refusal rights are not exercised in full, then the selling founder must allow the investors to sell a pro rata portion of their securities to the new investor. These are called “co-sale rights.” The rationale for these provisions is that the investors are investing in the company based on the participation and equity incentives of the founders and the founders are not supposed to be bailing out of the company before the investors. These provisions should be noncontroversial.

Sometimes an additional clause, called a “drag-along” right, is included in these agreements. With that clause, if a specified percentage of the investors wants to sell the company, then the founders agree in advance to be “dragged along” in the sale, that is to vote for that transaction and sign any agreements related to the transaction that the investors sign. These clauses are dangerous to the founders since there are many scenarios where the interests of the investors will differ from those of the founders. The investors may grow tired of a sideways investment and want to sell the company for the price they paid for their shares. Because they have a liquidation preference on such a sale (see Section 3:1), the investors would realize a return before other stockholders. The founders may have a different view of the desirability of the sale. One refinement on this type of clause is to impose certain economic and legal parameters for sales in which the founders can be compelled to participate.

— Investors Rights Agreement. This agreement is the vehicle for the investors to impose various affirmative and negative covenants on the company. The affirmative covenants typically include access rights, preparation of monthly financial statements, preparation of annual budgets, and a contractual pre-emptive right in the investors to purchase new securities issued by the company in order to maintain their percentage interest (with exclu-

sions typically similar or identical to those described above in the antidilution discussion). Negative covenants may include certain company specific items that are either not covered in the voting section of the corporate charter or are considered more appropriate in this agreement.

— Registration Rights Agreement. This agreement specifies the criteria and procedures for sales of shares into the public markets. The investors are the beneficiaries of these clauses, and sometimes the founders are as well.

These agreements provide for two different kinds of registration rights: “demand” rights and “piggyback” rights.

Demand rights entitle the investors to require the company to file a registration statement for all or a portion of their shares so they may sell them without restriction to the public. These rights usually become effective 180 days after the company’s initial public offering, effectively building in a “lock-up” for the investors that would normally be required by the underwriters in an IPO in any event. Demand rights will sometimes purport to allow the investors to force the company to do an IPO after a period of several years. There is then a battle over the appropriateness of this clause. As a practical matter, it is not possible to force the company to do an IPO (the participation of management is critical), so the battle (on both sides) should be saved for something else. This is the perfect opportunity for the VC to score some points as to its reasonableness and not include the ability to force an IPO.

Once the company has been public for a period of time (currently one year), the company becomes “S-3 eligible” and is permitted to file a short-form registration statement with the SEC. Because the S-3 procedures are streamlined, it is not uncommon that the VC’s require unlimited demand rights on Form S-3, typically with a minimum dollar amount of the securities required to be registered. Because the typical VC fund will have already distributed its company securities to its investors by the time the company is S-3 eligible, and because of the low cost of an S-3 registration statement, this clause is another one that is not worth battling over (by either side).

Piggyback rights allow the investors and sometimes the founders to add a portion of their shares to a registration statement filed by the company at its own initiative.

Because the sale of these “secondary” shares is a sensitive marketing issue in an IPO, registration rights agreements universally have a so-called “underwriter cut-back” provision. This provision cedes to the underwriters the determination whether inclusion of secondary shares in the offering is feasible from a marketing point of view. If, in the lead underwriter’s judgment, only a portion of the requested shares can be included, the registration rights agreement will frequently contain a priority allocation scheme among various tiers of investors and sometimes even among the founders.

These agreements also contain elaborate provisions dealing with registration procedures, indemnification for securities laws liabilities, and similar matters. These provisions are relatively standard and noncontroversial. Indeed, the registration rights agreement itself should not become the focus of too much attention or loss of good will. In an IPO or other public offering, as a practical matter, the underwriters call all of the shots, and the registration rights agreement is rarely taken out of the drawer other than to waive provisions objected to by the underwriters.

— **Other Agreements.** Other agreements required by VCs include: (i) so-called employee confidentiality and invention assignment agreements requiring all employees to maintain the confidentiality of the company’s confidential information and to assign to the company, at no cost, all inventions made by the employee that are related to the company’s business or that were made on company time or with use of the company’s resources, and (ii) noncompetition agreements from the founders and key managerial and technical personnel.

### § 3:18 Subsequent financing rounds

From a practical and legal perspective, subsequent convertible preferred stock financings should be, and usually are, less time-consuming and costly than a first-round financing. Typically the spoken or unspoken commitment on both sides is to complete the deal as expeditiously and simply as possible. Hopefully most of the major contentious issues will already have been worked out in the first round. It is usually agreed among counsel, particularly if the investors are largely the same as in the first round, to use the same

forms of documentation agreed upon in the first round. Normally, in order to keep the company's compliance requirements as simple as possible, all of the principal agreements are amended and restated and signed by all parties so that there is one integrated, completely consistent set of documents. In the corporate charter, the documentation merely requires adding the new series into a handful of appropriate points.

There are, however, a few new issues that arise in connection with a subsequent round financing. First, the relative priority of the two series of preferred stock must be agreed upon—that is, whether the new series ranks equally, or “*pari passu*,” with the prior series with respect to liquidation, dividends, and the like. Also, the Board composition must be agreed upon to include one or more designees of the new investors. Lastly, the various affirmative and negative covenants negotiated for the benefit of the first-round investors must be integrated into the new documentation. The preferred alternative for the company in that respect is to have only one set of covenants which are able to be waived by a specified percentage of the old and new investors as a group. The new investors may insist on their own separate set of covenants waivable only by a specified percentage of the new investors. In our view this is a shortsighted approach. In most cases any advantage to the new investors in having their own covenants to block certain actions that they disagree with will be outweighed by the ability of the other series of investors to block a transaction favored by the new investors. The best approach, in our view, is to integrate the covenants and provide for a waiver that allows an action to proceed if a majority (or if necessary a supermajority) of investors favors the action.

### § 3:19 Conclusion

The legal aspects of venture capital investments are perhaps the least important. The most important aspects are to secure a sound financing platform for the company's growth with investors that the founders believe they can work with and trust. The advantages gained or lost in the legal details rarely affect the success or failure of the investment from either the company's or the investors' point of view. That is not to minimize the key legal and economic provisions of a venture capital financing—valuation, Board

control, antidilution, and so forth.—but rather to point out that most of the documentation has become fairly standardized. The effort of all parties should be to focus on those few issues that are negotiable, and reach a prompt agreement on them so that everyone can get back to business.

**§ 3:20 Sample legal due diligence request list**

**Sample Legal Due Diligence Request List**

XYZ, INC.

Preliminary Legal Due Diligence Checklist

In each case, the requested information should be provided for the Company; for each of the Company's subsidiaries, if any; and for any entities affiliated with the Company where such information is material to the business of the Company or would otherwise be relevant.

**A. Corporate Records**

1. Corporate charter, as amended to date, including pending amendments.
2. By-laws or equivalent document, as amended to date, including pending amendments.
3. Minutes/other records of all proceedings of the Board of Directors (or equivalent body) and stockholders of the Company.
4. List of jurisdictions in which the Company does business, owns or leases real property, or otherwise operates and all foreign qualification documents.
5. List of subsidiaries and other entities in which the Company has an equity investment, if any.
6. Corporate records for subsidiaries.

**B. Stock Records/Documents**

1. Stock record books.
2. Current stockholder list, with names and addresses.
3. Copies of all employee stock option plans or other equity incentive plans, related agreements and a list of all outstanding stock options, including vesting schedules, exercise prices and dates of grant.
4. Copies of any agreements to which the Company is

a party relating to:

- (a) a commitment to issue or sell securities;
  - (b) a commitment or option to repurchase securities;
  - (c) past issuances or repurchases of securities (debt and equity);
  - (d) rights of first refusal;
  - (e) preemptive rights;
  - (f) restrictions on transfer of stock.
5. Warrants or other rights to purchase securities.
  6. Voting trusts or voting agreements to which the Company is a party or of which it is aware.

**C. Financial Records**

1. Audited financial statements for the last three fiscal years.
2. Most recent internal business plan.
3. Reports, studies, or appraisals on financial condition or business of the Company.
4. Auditors' management letters with respect to the last three fiscal years.
5. Latest internal financial statements.
6. Copies of all materials sent to all directors and/or all stockholders within last 12 months relating to the Company.
7. Tax returns and other correspondence with taxing agencies for the preceding three years.

**D. Financing Matters**

1. Credit agreements, loan agreements, and lease agreements.
2. Security agreements, mortgages, and other liens.
3. Guarantees by the Company of third-party obligations.
4. Agreements restricting the payment of cash dividends.

**E. Material Contracts, Agreements, and Policies**

1. All agreements between the Company and its directors, officers, subsidiaries, or affiliates (including information regarding unwritten commitments or understandings).
2. All (a) supply agreements, (b) VAR agreements, (c) distributorship agreements, (d) marketing agree-

- ments, and (e) product development agreements.
- 3. Documentation relating to:
  - (a) Investments in other companies or entities;
  - (b) Acquisitions of companies or assets;
  - (c) Disposition of assets.
- 4. Joint venture, cooperative, franchise, or dealer agreements.
- 5. List of principal or exclusive suppliers and vendors.
- 6. Any document restricting an issuance of the Company's securities.
- 7. Any standard customer terms and conditions of sale or license.
- 8. All other material contracts, agreements, and policies.

**F. Personnel Matters**

- 1. Employment and consulting agreements.
- 2. Nondisclosure, development, assignment, and non-competition agreements with any employee, consultant, or independent contractor and list of employees who are not parties to such an agreement.
- 3. Employee benefit plans, programs, or agreements (pension, health, deferred compensation, bonus, profitsharing, and any other benefit plans).
- 4. Loans and guarantees to or from directors, officers, or employees.
- 6. Personnel policies, manuals, and handbooks.
- 7. Resumes for all senior management of the Company (including all vice presidents).
- 8. List of all officers, directors, and key employees of the Company, including a schedule of all salaries, bonuses, fees, commissions, and other benefits paid to such persons (or accrued) for the latest fiscal year.
- 9. Agreements with unions, collective bargaining agreements, and other labor agreements.

**G. Intellectual Property Matters**

- 1. Schedule of all trademark, copyright, and patent registrations or applications, and related filings.
- 2. A catalog of each computer program used by the Company in the conduct of its business (the "Software Programs"), including, but not limited to, the title and description of each such Software Program.

3. All records and documentation maintained by the Company documenting the development, authorship, or ownership of the Software Programs and related technology.
4. List of all third-party software or other items or materials (including work under U.S. Government ownership) incorporated in the Software Programs.
5. List of all agreements or understandings with third parties, whether now in effect or terminated, for the design, development, programming, enhancement, or maintenance of the Software Programs.
6. List of agreements involving disclosure of source code relating to the Software Programs.
7. Description of the devices, programming, or documentation required to be used in combination with the source code relating to the Software Programs for the effective development, maintenance, and implementation of the Software Programs (for example, compilers, “work-benches,” tools, and higher-level or “proprietary” languages).
8. List of agreements, options, or other commitments giving anyone any rights to acquire any right, title, or interest in the Software Programs or related technology.
9. List of unregistered trademarks and service marks.
10. License and technology agreements.
11. All documents, materials, and correspondence relating to any claims or disputes with respect to any intellectual property rights of the Company or any of its subsidiaries or any third party.

#### **H. Real and Personal Property Matters**

1. List of all offices and other facilities.
2. Leases or subleases of real property.
3. Deeds and mortgages.
4. Purchase or lease agreements for material equipment or other personal property.

#### **I. Insurance Matters**

1. Summary of insurance coverage (casualty, personal property, real property, title, general liability, business interruption, workers’ compensation, product liability, key person, automobile and/or directors’ and officers’ liability, and self-insurance programs).

2. List of any insurance claims (whether or not settled) in excess of \$20,000 since incorporation.
3. Indemnification agreements.

**J. Legal Matters**

1. Threatened or pending litigation, claims, and proceedings.
2. Consent decrees, settlement agreements, and injunctions.
3. All attorney's "auditors letters" to accountants since incorporation.
4. Consents, decrees, judgments, orders, settlement agreements, or other agreements to which the Company is bound requiring or prohibiting any activity.

**K. Compliance with Laws**

1. Material government permits and consents.
2. Governmental proceedings or investigations threatened, pending, settled, or concluded.
3. Reports to and correspondence with government agencies.
4. Regulatory filings since inception.
5. All internal and external environmental audits.

**L. Business Information**

1. Press releases, articles, or promotional materials published about the Company since incorporation which are in the Company's possession.
2. Any external or internal analyses regarding the Company or its products or competitive companies or products.
3. Current backlog levels.
4. Copies of advertising brochures and other materials currently used by the Company.
5. Budgets or projections.
6. Product literature.

**§ 3:21 Sample term sheet for a first round venture capital financing**

**Sample Term Sheet for a First Round Venture Capital Financing**

TERM SHEET

FOR SERIES A ROUND OF FINANCING OF XYZ, INC.

Amount of Investment:	\$3,000,000	
Investors:	ABC Ventures DEF Capital	
Type of Security:	Series A Convertible Preferred Stock.	
Pre-Money Valuation:	\$7,000,000. <sup>1</sup>	
Capital Structure Following Series A Round:	Existing holders of Common Stock	55%
	Option Pool	15% <sup>2</sup>
	Holder of Series A Preferred Stock	30%
	Total	100%
Use of Proceeds.	The Company shall use the proceeds from this financing for working capital purposes.	

- Dividends: The Company will not pay dividends on its shares of Common Stock or any other stock which is junior to the Series A Preferred Stock unless a like dividend is paid on all shares of Series A Preferred Stock on a pro rata “as converted” basis.<sup>3</sup>
- Conversion: Each share of Series A Preferred Stock shall be convertible, at any time, at the option of the holder, into shares of Common Stock, at an initial conversion ratio of one share of Common Stock for each share of Series A Preferred Stock. Mandatory conversion of the Series A Preferred Stock upon the effectiveness of a registration statement covering a firmly and fully underwritten public offering of Common Stock of the Company by a reputable underwriter acceptable to the Investors at a price which equals or exceeds five times the purchase price per share of the Series A Preferred Stock and where the aggregate gross proceeds received by the Company exceeds \$25 million (a “Qualified Public Offering”).<sup>4</sup>

Antidilution: The terms of the Series A Preferred Stock will contain standard “weighted average” antidilution protection with respect to the issuance by the Company of equity securities at a price per share less than the applicable conversion price then in effect, subject to standard and customary exceptions.<sup>5</sup> The conversion rate of the Series A Preferred Stock into common stock will be adjusted appropriately to account for any stock splits, recapitalizations, mergers, combinations and asset sales, stock dividends, and similar events. Antidilution protection shall not be triggered by the issuance of up to 1,000,000 shares of Common Stock (or options therefor) issued in accordance with the Company’s Stock Option Plan.

Voting Rights: On all matters submitted for stockholder approval, each share of Series A Preferred Stock shall be entitled to such number of votes as is equal to the number of shares of Common Stock into which such shares are convertible. In addition, the Company shall not, without the prior consent of the holders of at least a majority of the then issued and outstanding Series A Preferred Stock, voting as a separate class:

- a) issue or create any series or class of securities with rights superior to or on a parity with the Series A Preferred Stock or increase the rights or preferences of any series or class having rights or preferences that are junior to the Series A Preferred Stock so as to make the rights or preferences of such series or class equal or senior to the Series A Preferred Stock.
- b) pay dividends on shares of the capital stock of the Company.

- c) effect any exchange or reclassification of any stock affecting the Series A Preferred Stock or any recapitalization involving the Company and its subsidiaries taken as a whole.
  
- d) repurchase or redeem, or agree to repurchase or redeem, any securities of the Company other than from employees of the Company upon termination of their employment pursuant to prior existing agreements approved by the Board of Directors of the Company.
  
- e) enter into any transaction with management or any member of the board of directors, except for employment contracts approved by the Board of Directors and transactions entered at arms-length terms which are no less favorable to the Company than could be obtained from unrelated third parties.
  
- f) effect any amendment of the Company's Certificate of Incorporation or Bylaws which would materially adversely affect the rights of the Series A Preferred Stock.

- g) incur or guarantee debt in excess of \$100,000.
- h) voluntarily dissolve or liquidate.
- i) effect any merger or consolidation of the Company with or into another corporation or other entity (except one in which the holders of the capital stock of the Company immediately prior to such merger or consolidation continue to hold at least a majority of the capital stock of the surviving entity after the merger or consolidation) or sell, lease, or otherwise dispose of all or substantially all or a significant portion of the assets of the Company.
- j) change the size of the Board of Directors or change any procedure of the Company relating to the designation, nomination, or election of the Board of Directors.

- k) amend, alter, or repeal the preferences, special rights, or other powers of the Series A Preferred Stock so as to adversely affect the Series A Preferred Stock.
  
- l) make capital expenditures of more than \$50,000 in a single expenditure or an aggregate of \$100,000 in any 12-month period.<sup>6</sup>

Liquidation Preference: The holders of Series A Preferred Stock shall have preference upon liquidation over all holders of Common Stock and over the holders of any other class or series of stock that is junior to the Series A Preferred Stock for an amount equal to the greater of (i) the amount paid for such Series A Preferred Stock plus any declared or accrued but unpaid dividends, and (ii) the amount which such holder would have received if such holder's shares of Series A Preferred Stock were converted to Common Stock immediately prior to such liquidation. Thereafter, the holders of Common Stock will be entitled to receive the remaining assets. For purposes of this section, a merger, consolidation, sale of all or substantially all of the Company's assets, or other corporate reorganization shall constitute a liquidation, unless the holders of at least a majority of the Series A Preferred Stock vote otherwise.<sup>7</sup>

Board of  
Directors:

The Board of Directors of the Company shall be comprised of five members. Of these five members, the holders of the Series A Preferred Stock shall have the right to designate two directors (one of such two directors to be designated by ABC Ventures, the other by DEF Capital) and the founders of the Company shall have the right to designate two directors. The remaining director shall be designated by such four directors.<sup>8</sup>

Options and  
Vesting:

All stock and options held by founders, management, and employees shall vest over a four-year period. Stock currently held by founders will be considered to be 25 percent vested as of the closing of this financing with the balance to vest in equal monthly installments over four years. All others shall vest in equal monthly installments over four years with a one-year cliff at the beginning of the vesting term. Change of control provisions to provide for no more than an additional 50 percent for founders and select management and one year for all others.<sup>9</sup>

Registration Rights: Commencing on the earlier of three years from the closing or six months after the effective date of the Company's first public offering, holders of shares of Series A Preferred Stock or shares of Common Stock issued upon conversion thereof ("Registrable Stock") shall have the right to demand two "S-1" registrations with aggregate gross offering price in excess of \$10,000,000, upon customary terms and conditions.

The holders of Series A Preferred Stock will also be entitled to unlimited "piggyback" registration rights on Company registrations.

The holders of Series A Preferred Stock will additionally be entitled to unlimited registrations on Form S-3 with at least \$1,000,000 in aggregate gross offering price, on customary terms and conditions.

The Company will bear all expenses related to all registrations and underwritings.

Affirmative  
Covenants:

While any Series A Preferred Stock is outstanding, the company will:

- a) maintain adequate property and business insurance;
- b) comply with all laws, rules, and regulations;
- c) preserve, protect, and maintain its corporate existence; its rights, franchises, and privileges; and all properties necessary or useful to the proper conduct of its business;
- d) submit all reports required under Section 1202(d)(1)(C) of the Internal Revenue Code and the regulations promulgated thereunder;
- e) cause all key employees to execute and deliver noncompetition, nonsolicitation and non-hire, nondisclosure, and assignment of inventions agreements for a term of their employment with the Company plus one year in a form reasonably acceptable to the Board of Directors;

f) not enter into related party transactions without the consent of a majority of disinterested directors;

g) reimburse all reasonable out-of-pocket travel-related expenses of the Series A Preferred Stock directors.<sup>10</sup>

Financial  
Statements  
and Reporting:

The Company will provide all information and materials, including, without limitation, all internal management documents, reports of operations, reports of adverse developments, copies of any management letters, communications with stockholders or directors, and press releases and registration statements as well as access to all senior managers as requested by holders of Series A Preferred Stock. In addition, the Company will provide the holders of Series A Preferred Stock with unaudited monthly and quarterly and audited yearly financial statements, as well as an annual budget.

Redemption: Commencing with the date that is five years from the date of closing and on each one-year anniversary of such date thereafter, holders of at least a majority of the then issued and outstanding shares of Series A Preferred Stock may request the Company to redeem their shares at a price equal to the original purchase price for such shares plus any declared but unpaid dividends, with  $\frac{1}{3}$  of the shares to be redeemed on such redemption date, an additional  $\frac{1}{3}$  on the date that is one year from such date, and the remaining  $\frac{1}{3}$  on the date that is two years from such date.<sup>11</sup>

Right of First Refusal: Holders of Series A Preferred Stock shall have a pro rata right, based on their percentage of fully diluted equity interest in the company, with an undersubscription right up to the total number of shares being offered, to participate in subsequent stock issuances.<sup>12</sup>

Right of First Refusal and Co-Sale: In the event that any of the founders and existing executive management propose to sell their stock to third parties, the Company shall have the first right to purchase the securities on substantially the same terms as the proposed sale; the Series A Preferred Stockholders shall next have said right according to respective percentage ownership of Series A Preferred Stock or to sell proportionate percentage pursuant to co-sale rights. Such rights shall terminate upon a Qualified Public Offering.

Other Provisions: The purchase agreement shall include standard and customary representations and warranties of the Company and the other agreements prepared to implement this financing shall contain other standard and customary provisions. Definitive agreements will be drafted by counsel to the Investors. This term sheet is intended by the parties to be nonbinding.<sup>13</sup>

- Expenses: The Company will reimburse the holders of Series A Preferred Stock for reasonable legal fees in connection with the transaction, payable at closing and only in the event that the transactions contemplated by this term sheet are consummated, up to a limit of \$25,000.<sup>14</sup>
- Conditions to Closing: Closing shall be subject to the standard and customary conditions, including the completion of due diligence and the delivery to the investors of a legal opinion of counsel to the Company, regarding standard and customary matters and satisfactory to the Investors and their legal counsel.<sup>15</sup>

<sup>1</sup>Equals the value the new investors are placing on the enterprise prior to their investment. In calculating the price per share that will be paid by the new investors, usually all of the outstanding stock of the company, together with any outstanding options and warrants or other rights to buy stock of the company and any additional shares which may be reserved under the option pool, will be included in this pre-money valuation.

<sup>2</sup>The size of the option pool that venture capital investors will look for ranges between 15% and 30% of the capital structure of the company. This percentage is calculated including the shares of Series A Preferred Stock being sold in the financing. The actual size of the pool can depend on a number of things, including the industry that the company is in, but is primarily related to the number and types of hires which the company will need to make in the foreseeable future. Thus, a company which has a complete management team at the time of the Series A round will likely need a smaller pool than a company which has one or more top management hires to make (each of whom may cost the company a significant amount of options or stock from the pool).

<sup>3</sup>Often, venture capital investors also ask for an “accruing” dividend of between 7% and 10% or so per annum. This dividend “accrues” and is not payable unless (i) declared by the Board, (ii) there is a liquidation event (a sale of the company is considered a liquidation event, but an IPO usually isn’t), or (iii) the preferred stock is redeemed. The accruing dividend is a protective device intended to provide a minimum rate of return but is usually forfeited in the event of an IPO or otherwise upon conversion of the preferred stock to common stock (the theory being that in such cases the return on the investment will be more than the minimum which the accruing dividend provides; therefore, the protection is not needed and is forfeited). There are a number of varieties of accruing dividends, including those that are payable in cash and those payable in additional shares of preferred stock. Also, although a basic “accruing dividend” involves a simple interest calculation, sometimes investors request a compound interest calculation.

<sup>4</sup>Preferred Stock should convert into common stock automatically at the company’s IPO. The special rights generally accorded to preferred stock sold to early-stage investors could create problems for a public company. The concept of a Qualified Public Offering is designed to protect the investors from a forced conversion and loss of other rights if a small public offering is done which does not result in sufficient liquidity of the common stock.

<sup>5</sup>These provisions are designed to protect an investor against “equity” dilution (later sales of stock at a price lower than what the investor paid). Although the “weighted average” version is the most common, an alternative is “full ratchet” antidilution protection. Full ratchet antidilution protection is far more advantageous to the investor (but punitive to the company) than weighted average, but is usually reserved for very early stage deals or other situations where there is significant concern as to whether the valuation will hold up over the long term. Put simply, weighted average antidilution protection accounts more accurately for the actual dilutive effect which a particular issuance has on the investor’s equity position in the company. Weighted average antidilution adjustment provides for a more significant adjustment in the conversion rate of the preferred stock in the event of the issuance of a significant number of shares of stock at a lower price and a less significant adjustment in the event of the issuance of a small number of shares at such lower price. Full ratchet antidilution protection, on the other hand, treats all later stock issuances below the investor’s purchase price as if they were the same, regardless of the number of shares issued. Thus, full ratchet antidilution adjustment results in the same adjustment to the conversion rate (to the price paid per share for the later issued shares) regardless of the number of shares actually sold.

<sup>6</sup>Although there are venture capital investors that ask for other veto rights, this list covers some of the most frequently occurring. You may not have to provide veto rights with respect to each of these matters. The key here is to try to limit these to major corporate events and to try to avoid turning day-to-day operational matters into matters for a preferred stockholder vote. Thus, for example, (g) and (l) could be problematic if the dollar limits are too low. Often a compromise may be reached with respect to a request for a veto right on an operational matter by agreeing that such would be subject to the veto of the Series A Preferred's director but not at the stockholder level, thereby keeping the issue at the board level—where it belongs.

<sup>7</sup>This is a so-called “straight” liquidation preference. An alternative is the “participating” liquidation preference (sometimes referred to pejoratively as a “double dip” liquidation preference) which provides that the preferred stock gets an amount equal to its money back (plus any accrued dividends if there is an accruing dividend) and then participates with common stock on an “as-converted basis.” A participating liquidation preference is a pricing term most often seen only in early-stage deals or in “down rounds.”

<sup>8</sup>Working out what the Board will look like following the Series A round will be one of the most important matters to deal with. Generally, the Series A investors will ask for and receive representation on the Board. The questions will be how many seats do they get and what effect will that have on the founders' and management's Board representation. In the end, everybody involved will need to participate in, and be satisfied with, the decisions regarding board structure.

<sup>9</sup>Venture capital investors will likely impose a vesting schedule on stock and options held by founders, management, and employees as a condition to investment. If shares or options are subject to vesting, they are subject to being lost if the person ceases to work for the company for any reason. Venture capital investors impose such vesting requirements in order to provide the company's people with a reason to stay with the company. Also, if a person ceases to work for the company for any reason, the non-vested shares are available for grant to his or her replacement. The theory here is, of course, that the best business plan is worth nothing without the people to execute it.

<sup>10</sup>This list includes items frequently and consistently looked for by venture capital firms.

<sup>11</sup>This is simply a right to achieve liquidity in the event that the company does not otherwise reach a sale or IPO by the end of the selected time period. Since the company cannot redeem stock if to do so would render the company insolvent, this right is only useful in situations in which the company has become some sort of a sideways play. Usually the redemption price is the price paid for the stock plus the accruing dividend if there is one. Occasionally, venture capital firms will request that the redemption price be at the greater of such price and the then fair market value of the stock. The only thing to really watch out for here is to make sure that the company can pay the redemption out over time (three payments over two years is so common as to be almost standard).

<sup>12</sup>While this is generally asked for and received by venture capital investors (who can give you a yes or no quickly without the need for elaborate disclosure documents to comply with the securities laws), a company should think about resisting this request if it comes from individual investors.

<sup>13</sup>The term sheet should be nonbinding (with the exception only of the exclusivity provision, if there is one, and any provisions regarding confidentiality).

<sup>14</sup>How much usually depends on where the lawyers are from. Make sure that there is a cap. You may also want to resist any request to pay ongoing fees for the cost of complying with requests for waivers, etc., after the closing (except to the extent to which they incur fees because the company breaches its obligations to them).

<sup>15</sup>Be on the lookout for any exclusivity provisions (which may be acceptable, but only to a point). Usually, these exclusivity provisions require the company to refrain from taking an investment from anyone else for a set period of time after the term sheet is signed. While an exclusivity provision may be acceptable (and is often imposed), be sure to pay attention to the time period. It should be no longer than is necessary to complete the transaction with a little extra time for possible delays. Thirty days should be acceptable in most instances; 60 days is pushing it in most instances; and 90 days is probably unreasonable in almost all cases. Also, make sure that the exclusivity period automatically ends in the event that the deal is called off by either party before the period expires.

By:\_\_\_\_\_ By:\_\_\_\_\_

§ 3:22 **Sample closing agenda for a convertible preferred stock financing**

**Sample Closing Agenda for a Convertible Preferred Stock Financing**

XYZ, INC.

Sale and Purchase of  
Series A Convertible  
Preferred Stock

Closing Agenda

[Date]

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**Abbreviations**

XYZ, Inc., a Delaware corporation

Company

Purchasers

Founders

Company

Counsel

Investors

Counsel

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**Transaction Documents**

**Responsibility**

- |  |   |
|--|---|
| <p>1. Series A Convertible Preferred Stock Purchase Agreement dated [____] by and among the Company, the Purchasers, and the Founders (the “Purchase Agreement”)</p> | <p>Investors<br/>Counsel as to drafting;<br/>Company<br/>Counsel as to signatures from Company and Founders</p> |
| <p>2. Financial Statements furnished pursuant to the Purchase Agreement</p>  | <p>Company</p>  |
| <p>3. Disclosure Schedule to the Purchase Agreement</p>  | <p>Company;<br/>Company<br/>Counsel</p>   |
| <p>4. Amended and Restated Certificate of Incorporation</p>  | <p>Investors<br/>Counsel as to drafting;<br/>Company<br/>Counsel as to signature from Company</p>               |
| <p>5. Right of First Refusal and Co-sale Agreement</p>   | <p>Investors<br/>Counsel as to drafting;<br/>Company<br/>Counsel as to signatures from Company and Founders</p> |

**Transaction Documents**

**Responsibility**

6. Investors Rights Agreement

Investors  
Counsel as to  
drafting;  
Company  
Counsel as to  
signature from  
Company

7. Registration Rights Agreement

Investors  
Counsel as to  
drafting;  
Company  
Counsel as to  
signatures from  
Company and  
Founders

8. Stock Restriction Agreements

Investors  
Counsel as to  
drafting;  
Company  
Counsel as to  
signatures from  
Company and  
Founders

**Corporate Organization, Existence,  
Qualification, and Authority**

9. Board resolutions of the Company

Company  
Counsel

10. Stockholder resolutions of the  
Company

Company  
Counsel

11. Certificate of Good Standing of the  
Company from the Secretary of State  
of the State of Delaware

Company  
Counsel

<u>Transaction Documents</u>	<u>Responsibility</u>
12. Certificate of qualification to do business of the Company from the Secretary of State of [____]	Company Counsel
 <u>Closing Documents</u>	
13. Certificate of the Secretary or the Assistant Secretary of the Company as to (i) Certificate of Incorporation, (ii) By-Laws, (iii) Board of Directors and Stockholders resolutions, and (iv) incumbency	Company Counsel
14. Certificate of an Officer of the Company as to (i) representations and warranties, and (ii) conditions required to be performed	Company Counsel
15. Opinion of Company Counsel	Company Counsel
16. Form of Employee Nondisclosure and Developments Agreement by and between the Company and each employee	Company Counsel
17. Form of Key Employee Noncompetition, Nondisclosure, and Developments Agreement by and between the Company and each Key Employee	Company Counsel
18. Stock Restriction Agreements between Company and each Founder	Company Counsel
19. Consent and Waiver pursuant to Section [____] of the Purchase Agreement	Company Counsel

<b><u>Transaction Documents</u></b>	<b><u>Responsibility</u></b>
20. Wire instructions provided by the Company	Company
21. Series A Preferred Stock certificates issued to the Purchasers	Company Counsel
22. “Blue sky” state securities filings in connection with sale of shares of Series A Preferred Stock	Company Counsel
23. Form D filed with the SEC in connection with sale of shares of Series A Preferred Stock	Company Counsel
24. “Blue sky” state securities filings in connection with sale of shares of Series A Preferred Stock	Company Counsel