

VENTURE STAGE FINANCING

A common form of raising early-stage working capital is through the sale of securities to venture capital firms or to “angel” investors. Venture capital firms are generally investment funds which specialize in investing in early-stage or high-risk ventures. Angel investors are high net worth individuals who are willing to make the same type of investments.

THE INVESTOR’S PERSPECTIVE

Both venture firms and angel investors make high-risk investments to receive a profitable return. While there are notable differences between the two, the motivations and the financing processes are largely the same and both are interested—primarily—in the amount and timing of their returns. Some angel investors may be more flexible than venture firms, which typically maintain rigorous policies to reduce portfolio risk. For example, a communications industry veteran investing his own money may be more flexible (and possibly more empathetic) when investing in a communications start-up than a venture firm which might require the company to sign more comprehensive covenants. Of course, there is relatively little investment money to be found from such angel investors and the vast majority of angels (and certainly those who make large numbers of investments) should be treated in most respects exactly like a venture firm. Accordingly, except where otherwise noted, the discussion contained in this Section encompasses both types of investors.

Venture Capital Firms

Venture capital firms are investment funds or capital pools organized principally to purchase equity early in a company's life cycle, guide the company through any growing pains, and then make an exit once a large return on their investment has been made. Venture capital firms are managed by a group of partners who are each knowledgeable and well-connected in their chosen industry. These individuals are responsible for finding the portfolio companies, negotiating the financing terms and providing subsequent guidance to the company. Venture firms typically can provide very helpful business insight and direction but their guidance may also be a source of problems. Among other things, they can be useful in recruiting management, keeping management focused, locating vendors or distribution channels and generally making the right connections. Moreover, they are often invaluable when seeking additional future funding. The flip side is that a venture firm may demand more control of the company, for example through percent of ownership or number of board seats, than the entrepreneur wants to give.

Angel Investors

Angels may or may not possess the same level of expertise as venture capitalists. Many angels are entrepreneurs who have found success, possibly in the same industry. Such savvy angels certainly can (and may demand to) provide helpful guidance. Others might simply be moneyed individuals who can afford to make high-risk investments and then sit silently on the sidelines.

WHAT THE VENTURE CAPITAL INVESTOR IS LOOKING FOR

It is difficult to judge the worth of early-stage companies and venture investors take extreme care when selecting their portfolio companies. They accept extraordinary risks because of potentially extraordinary rewards. Investment returns of 35 percent per year are not uncommon. One rule of thumb is that venture capital firms look for a return of three to five times their investment in five to seven years. One or two investments of every ten made by the investor may reach these heights. The investor may more or less break even on another five to seven investments of the ten and lose money on two or three.

Venture firms receive thousands of business plans a year. Around 90 percent of these plans are quickly rejected either because they are poorly prepared or because they do not fit the specific geographical, technical or market niches that the venture capital firm is seeking. Angel investors also are extremely selective. Few plans warrant a face-to-face presentation. Even fewer actually receive funding.

Most venture firms maintain internal policies which set thresholds for deal size and company maturity and provide evaluation protocols. Candidate companies are diligently investigated. Venture investors consider the quality of the business plan and idea; the character, experience and reputation of the management team; the size and accessibility of the existing and potential market; and the availability of future exits. Consultants may be hired to fully evaluate prospects, especially when considering any new or complex technologies. The market size and competitive position of the company are also measured. The investors may interview present and potential customers, vendors and others. Production costs are reviewed. The company's budget is thoroughly analyzed and the time to market for potential products is estimated. The financial condition of the company is generally confirmed by an auditor and a review of the company's legal status is made.

Investment Size

The typical venture investor is interested in making an investment of \$250,000 to \$5,000,000. Projects of under \$250,000 are usually rejected because of the high cost of evaluation and administration while those over \$5,000,000 may present exposure problems to the investor. A number of investors may invest in each round of financing. Depending on funding needs, start-ups should be prepared to allocate at least 20-30 percent of the company to these investors in the first round of financing (or "series A" round, with subsequent rounds called series B, series C and so on). Usually the series A financing will require aggregate funding of around \$5,000,000, with subsequent rounds increasing in size as the company's capital needs grow.

Company Maturity

Most venture investors limit their interest to companies with some operating history, although the investors may not require the company to have already generated a profit. Companies that can use additional funds to readily expand into a new product line or a new market are particularly attractive. Such companies can use venture money to grow quickly rather than gradually as they would on retained earnings. Depending upon the existing risk in the venture investor's portfolio, companies that are just starting out or that have serious financial difficulties may be of interest if the potential for significant gain can be identified and assessed. A small number of venture investors will do only "start-up" or "seed capital" financing.

Company Management

Most venture investors concentrate initially on the competence and character of the company's management team. Venture investors look for a group that is able to work together easily and productively, especially when under stress from temporary reversals and

competitive problems. Investors know that even excellent products can be ruined by mismanagement.

Some venture investors invest primarily in management capability and not in product or market potential. Toward this end, they may spend a week or more at the offices of the candidate company talking with and observing management. Depending on the company's maturity, venture investors like to see a complete and focused team already managing the important functional areas (product design, marketing, production, finance and control). Responsibilities should be clearly assigned and, in addition to a thorough understanding of the industry, each member of management must be firmly committed to the company and its future.

The Business Plan and Idea

Most venture investors seek a distinctive element in the company's strategy or product/market/process combination. This distinctive element may be a new feature of the product or process or a particular skill or technical competence of the management, but should provide an actual competitive advantage.

SUMMARY OF THE PROCESS

Once an initial evaluation has been made and the venture investor has decided to proceed, the financing process will likely move quickly. The investor will propose a term sheet setting forth the terms of and conditions to the financing. If there is more than one participating venture investor, the largest investor will likely take the lead, negotiating and investigating on behalf of the others. The term sheet may be a rather comprehensive document and may be negotiated for some time or it may be a relatively scant document containing little more than a valuation of the company.

Among other things, the term sheet will value the company. Venture valuations seldom correlate to tangible measurements like price to

earnings ratios, but instead emerge from other factors including management's contacts, abilities and prior record, as well as the intellectual property portfolio and the market attractiveness of the particular niche.

Until closing, the venture investors typically will continue investigating the entity. This "due diligence" investigation provides them with a comprehensive look at the strategic, financial and legal status and outlook of the company. The investors' analysts and attorneys may at this time make an exhaustive review of the company's intellectual property portfolio, corporate documents, existing contracts and financial data.

Once the term sheet has been substantially finalized, the certificate setting forth the terms of the purchased securities, the purchase agreement itself and other documents will be drafted and negotiated. The investors and the company then will sign the various documents and the investment will be made.

PRINCIPAL TERMS OF CONVERTIBLE PREFERRED STOCK

Typically venture investors purchase preferred stock which is convertible into the company's common stock. Preferred stock offers great flexibility because it gives the investors the rights they want while using traditional equity concepts to align the incentives of the investors and the company. The venture investors will require that the company file an amendment to its articles or certificate of incorporation identifying this preferred stock in accordance with negotiated terms. These preferred stock terms should be carefully considered and likely will be among the more heavily-negotiated deal provisions. The prevalent terms fluctuate with the economy, and the investor's or the company's market and they vary from industry to industry. The specific negotiations will proceed depending on each particular company and the parties' respective bargaining powers.

The section below discusses typical preferred stock terms.

Dividends

- **Rate.** Fixed dividends and the dividend rate are negotiable terms that depend on the investors' objectives. Typically, venture investors do not expect to receive current dividends, preferring instead to keep the money in the company.
- **Cumulative.** Cumulative dividends accrue even if unpaid and must be paid before any dividends are paid on common stock. Depending on current market conditions, investors usually do not require cumulative dividends.
- **Participating.** Participating preferred stock permits holders to participate again in all dividends paid on common stock after dividends are first paid on preferred stock. This may not be as important to investors as other provisions because dividends are usually not paid on common stock until after the preferred stock has been converted.

Liquidation Preference

Venture investors will likely require that they, as holders of preferred stock, be paid immediately after creditors are paid and before any assets can be distributed to other equity holders. This "liquidation preference" usually is the original price (or two or three times that, depending upon negotiations) paid for the preferred stock plus all accumulated and unpaid dividends. Preferred stock may also be "participating" with regard to liquidation, allowing preferred stock to share ratably in distributions to holders of common stock after the liquidation preference has been paid, either on an unlimited basis or until the investor has received a set return on the investment (for example, three or four times the original price of the preferred stock). Holders of preferred stock will also have the option to convert their preferred stock to common stock if distributions to the holders of the

common stock exceed the liquidation preference for the preferred stock. Usually the investors will require that mergers or material acquisitions as well as substantial sales or exclusive licenses give rise to this right.

Conversion

Preferred stock will almost always be convertible into common stock at the option of the holders at any time. In addition, preferred stock will often be subject to mandatory conversion upon certain events, such as an underwritten public offering with a minimum per share price and minimum aggregate proceeds going to the company. Mandatory conversion may also be automatic upon the achievement of defined financial objectives or by the vote of some specified majority of the preferred stock holders.

- **Rate.** The conversion rate is usually set by establishing a conversion price per share of common stock. Generally, the initial conversion price is the same as the price per share paid by the investors for the preferred stock and is subject to adjustment for antidilution protection.
- **Antidilution Protection.** Conversion terms are structured to protect the preferred stockholders' percentage of holdings and rights from being diluted as a result of stock splits or similar recapitalizations, sales of common stock, other preferred stock or the equivalent at prices lower than the price of the subject preferred stock, and mergers and consolidations.
 - **Stock Splits and Recapitalizations.** At a minimum, the preferred stock conversion rate is subject to adjustment to reflect the effects of stock splits and similar recapitalizations. For instance, if a two-for-one split of common stock is declared, the conversion price will be reduced by one-half and the preferred holders will receive twice as many shares of common stock upon conversion.

- **Protection Against Dilutive Sales of Common Stock or its Equivalent.** The conversion rate will usually be adjusted to give the holders of preferred stock the right to receive additional shares of common stock if the company sells securities (including warrants or options) at prices lower than the then effective conversion price. The adjustment may be based on the “weighted average” price paid for all outstanding shares (including shares issuable upon exercise of options and warrants) or it may simply adjust the conversion price to the lowest price paid for common stock (or the lowest price at which options or warrants are exercisable) under a more investor-friendly “full ratchet” adjustment. In most cases, the antidilution protection does not apply to the issuance and exercise of options granted to employees up to some fixed number of shares or some fixed percentage of the number of outstanding shares of common stock.

- **Pay to Play.** Some investment agreements have a “pay to play” clause which limits antidilution protection to those investors who make an additional pro rata investment in a future dilutive round of financing. More aggressive “pay to play” provisions will penalize an investor who does not participate in a future round of financing by automatically converting the investor’s preferred stock into common stock.

- **Provisions for Mergers and Consolidations.** The conversion terms usually are structured to permit the holders of preferred stock to have the right following a merger or consolidation to convert their preferred stock into the number of shares of stock of the surviving company that they would have received had they converted the preferred stock immediately prior to the merger or consolidation.

Voting Rights

- **Regular Voting Rights.** Preferred stock usually has the right to vote the number of shares of common stock that would be received upon conversion on all matters submitted to a vote of shareholders.
- **Rights to Elect Directors.** Preferred stock voting as a single class may have the right to elect a fixed number of directors which may roughly equate the percentage of the company that the investors are purchasing. For example, if the investors are purchasing 20 percent of the company, they may expect to vote exclusively on 20 percent of the board seats (in addition to voting alongside the common stock with regard to the other seats). Additionally investor dynamics may play a role. Two large investors may insist that they each have a board seat. To this end, a separate voting agreement might be signed by the investors, the company and the principal shareholders. The board will likely grow alongside the number of financings with, for example, the series A, B and C holders each electing one seat separately.
- **Rights Upon Default.** Preferred stock voting as a single class often has the right to elect a majority of the company's board of directors upon a default by the company under the investment agreement.
- **Other Special Voting Rights.** Often certain actions will be prohibited without the approval of the preferred stock voting as a single class (sometimes by a supermajority vote). Such actions may include: the issuance of a new class or series of stock; amendments to the company's articles or certificate of incorporation or bylaws; redemptions of stock; payment of dividends; increases to the Company's stock option pool; or mergers or material dispositions of assets.

Redemption Rights

- **Redemption at the Option of the Investor.** Preferred stock often is “puttable” or redeemable at the option of the investor at some fixed price, sometimes including a premium over the original issuance price plus accumulated and unpaid dividends. The investors’ right to put the preferred stock will usually only arise after a fixed period of time. In some circumstances, the preferred stock is “callable” or redeemable at the option of the company.
- **Mandatory Redemption.** The company will often be required to redeem the preferred stock (again, sometimes at a premium over the original issuance price) after a fixed period of time or upon certain other events, such as the death of a key employee. It is important that mandatory redemption be structured to ensure that the company will continue to have sufficient liquidity. The company may be required to establish a sinking fund or maintain key person life insurance policies to finance mandatory redemptions. Any redemptions will be subject to state corporate law restrictions on distributions to equity holders.

Preemptive Rights

Preemptive rights give an investor the right to maintain the investor’s current level of ownership in a company by purchasing, during a limited time period, the investor’s pro rata portion of any additional securities sold by the company. Sometimes investors are also given the right to exercise the preemptive rights of other investors who fail to purchase their entire pro rata portion of such additional securities being offered. In most cases, preemptive rights do not apply to the issuance and exercise of options granted to employees up to some fixed number of shares.

THE INVESTMENT AGREEMENT

A comprehensive investment agreement (usually a stock purchase agreement) will serve as the operative document with other important documents deriving from the same. Together, these memorialize the various terms and conditions of the purchase of convertible preferred stock by the venture investors. Each provision should be carefully read and considered. The sections below discuss typical treatments.

Representations and Warranties

The company will likely be required to make extensive “representations” (legally binding assurances) and “warranties” (legally binding guarantees) regarding its formation, capitalization, authority to enter into the agreement, financial condition, contracts, litigation, employees, defaults and other matters. The agreement will provide for a “disclosure schedule” or “schedule of exceptions” which will include specific exceptions to the company’s representations and warranties. The goal here is to provide the investors with all pertinent information concerning the company.

The investors too will make representations and warranties regarding their authority to enter into the agreement and certain other items necessary for the company to comply with exemptions to the registration requirements of federal and state securities laws.

Affirmative Covenants

The company will likely be required to comply with “affirmative covenants” (legally binding promises to do certain things) including the maintenance of corporate existence in good standing, corporate books and records, properties and insurance, a fixed structure of its board (and the provision of investors’ rights to observe board meetings or elect a number of directors), and key person life insurance.

Additional affirmative covenants typically include providing financial statements and rights of inspection, preparing annual budgets, payment of taxes, application of the financing proceeds for specified purposes, compliance with laws, applying for and maintaining rights to patents, trademarks and copyrights, obtaining confidentiality agreements, and obtaining agreements regarding ownership of inventions and non-competition agreements with new employees.

Negative Covenants

The company typically will be subject to “negative covenants” (legally binding promises **not** to do certain things) which prevent the company from taking certain actions without the approval of the investors. Negative covenants may include restrictions on mergers and acquisitions, dispositions of assets or purchases of capital equipment, payment of dividends, issuances of securities unless the investors are given a right of first refusal to purchase such securities, granting registration rights to other investors, making corporate guaranties, loans or investments, increasing salaries, amending charter documents, entering into new lines of business, and violating financial covenants such as those requiring the maintenance of a minimum net worth or a minimum liquidity ratio.

Termination of Covenants

Usually the affirmative and negative covenants will terminate when the investors no longer hold a minimum percentage (often 15 to 25 percent) of the purchased securities. The covenants should additionally terminate upon the closing of a public stock offering at a minimum per share price with minimum aggregate proceeds received by the company.

Closing Conditions

The purchase agreement will provide that the investors are not required to invest until certain conditions are met or waived by the investors. Typically such closing conditions require that:

- The amendment to the company's articles or certificate of incorporation that issues the preferred stock has been filed with the relevant state authority;
- The representations and warranties are accurate as of the closing date;
- The company has complied with the investment agreement and is not in default;
- Certain officers have certified as to the accuracy of the representations and warranties, that the company has complied with the agreement and that no defaults exist on the closing date;
- The company's counsel has delivered an opinion as to various matters, including valid corporate organization and existence, due authorization, execution and delivery of the agreements, due authorization and issuance of securities, proper corporate proceedings, compliance with securities laws, and no conflicts with the company's charter documents and other agreements;
- Certain documents have been delivered, including certified resolutions of the company's board of directors, incumbency certificates, and certified articles or certificate of incorporation and bylaws; and
- If necessary, certain agreements such as voting agreements, employment agreements, and right of first refusal and co-sale agreements have been executed and delivered.

Registration Rights

Registration rights give security holders the right to cause the company, under defined circumstances, to register their shares under the Securities Act and applicable state securities laws to permit public resale of such shares. Usually registration rights apply only to the common stock issuable upon conversion of the preferred stock or debentures or the exercise of warrants held by the investors, although the rights could extend to other securities.

- **Demand Rights.** Demand registration rights permit the shareholders to initiate a registration by requiring that the company prepare, file and maintain an effective registration statement for the shares. Usually demand rights may be exercised only when investors holding a minimum number of securities demand registration. Demand rights are normally exercisable only after a specified period of time has lapsed because most start-up companies are not in a position to file a registration statement in the first few years of development. Typically the investors will only be permitted to exercise demand rights once or twice.
- **Incidental or “Piggyback” Registration Rights.** Piggyback registration rights permit shareholders to include their shares in registrations initiated by the company and, sometimes, by other investors. Usually there is no restriction on the number of times that piggyback registration rights may be exercised, but there may be a time limit on the exercise of rights, such as three or five years after the company first goes public. Piggyback rights typically do not apply to registration statements prepared by the company in connection with mergers or acquisitions or in connection with the registration of shares under employee benefit plans.

- **Cutback Provisions.** Cutback provisions permit the company to exclude shares held by investors from a registration if the underwriter concludes that inclusion of the shares may adversely affect the market for shares being sold by the company. In the company's initial public offering, the investors' piggyback registration rights may be subject to a total cutback, while in subsequent registrations the cutback provisions may permit the investors to have some specified percentage of the offering, usually 15 to 25 percent.
- **Short-Form Registration.** The agreement may grant additional rights to the investors to exercise demand registration rights if a Form S-3 registration is available to the company. Form S-3 is an abbreviated registration form that is easier and less expensive to prepare, but is only available to certain public companies. The number of times that Form S-3 registrations may be demanded is usually limited to some number per year (usually two or three), rather than an overall number, and the minimum number of shares required to trigger registration on Form S-3 is usually specified.
- **Payment of Expenses.** The company will generally pay all expenses of registration and sale, other than underwriting commissions on the investors' shares. At times, investors are required to pay the expenses of registration on Form S-3.

Rights of First Refusal and Co-Sale Rights

Venture investors will usually require that the existing principal shareholders enter into a separate co-sale agreement that gives the investors the right of first refusal and co-sale rights with regard to proposed sales of securities by the principal shareholders. This is chiefly designed to ensure that the pre-money principal shareholders (typically the founders) remain with the company.

Provisions for Waivers and Amendments

The investment agreement will usually provide that the investors may waive or amend any provision of the agreement with the consent of fewer than all of the investors. If waivers or amendments can be effected with a majority or a supermajority, it becomes less likely that one or two small investors will be able to exercise leverage over the company or the other investors.

THE CLOSING

Once the terms have been conclusively negotiated, the company and investors will sign the investment agreement along with the ancillary documents. The financing will then proceed as soon as all closing conditions have been met or waived. There may be follow-up closings by additional investors on the same round of financing until the express financing need has been met and the round closed.