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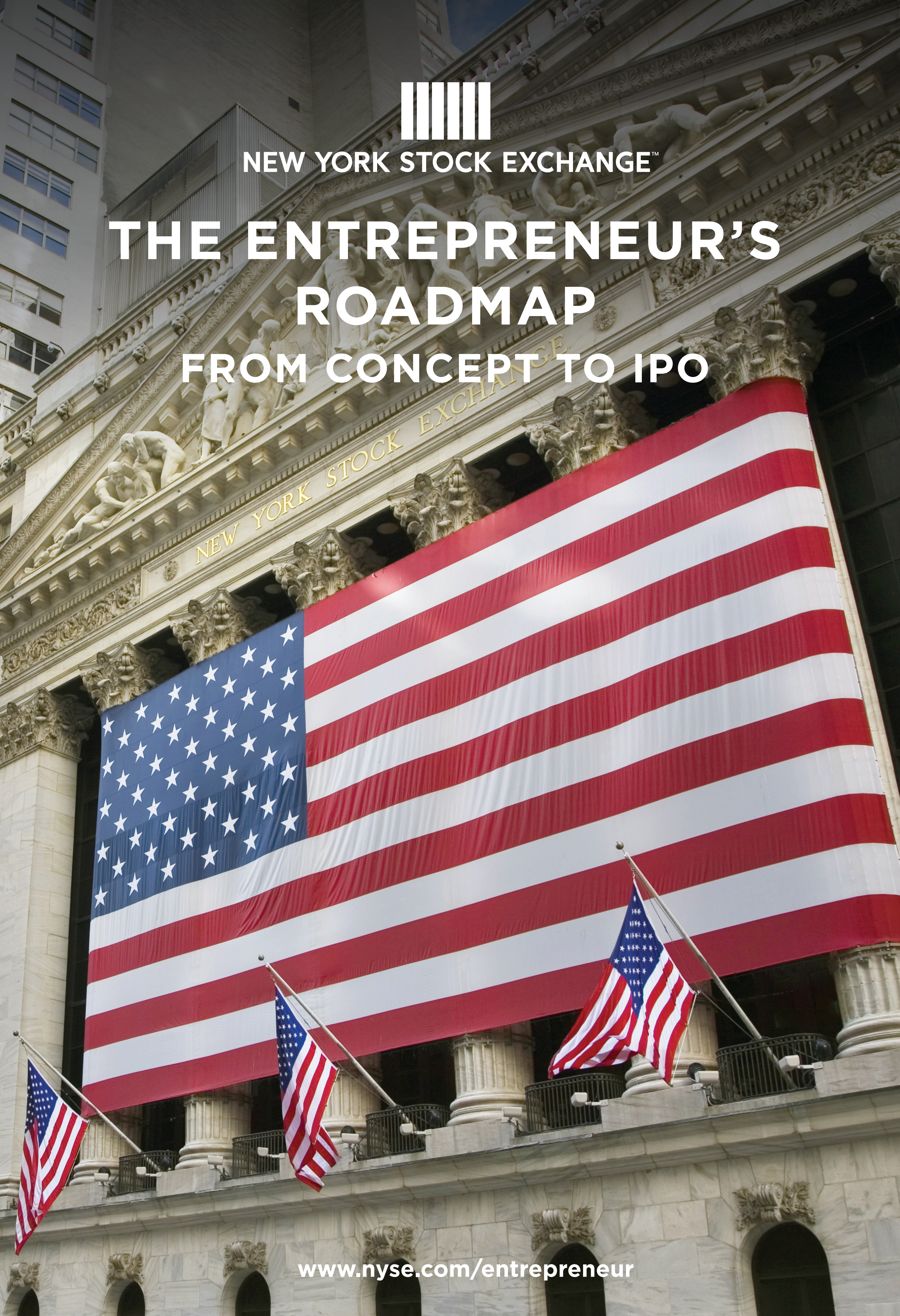

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11

LEGAL ISSUES IN RAISING CAPITAL

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In this chapter, we'll review the three most important legal provisions that a company should consider as it raises venture capital. But before we dig into these provisions, we should quickly review the overall structure of a venture capital financing.

In general, the legal terms from one venture financing to the next are more similar than they are different, reflecting the venture capital community's status as a body with more or less common norms and guidelines. Since 2005, this commonality has been further enhanced through the availability of model legal investment documents on the website of the National Venture Capital Association (NVCA). The NVCA forms are influential in venture capital investing today and are often helpful for resolving points in an individual transaction among parties trying to find compromise language. Although an individual venture capital financing almost invariably includes legal provisions customized to meet the needs of the company and its investors, the NVCA forms provide a window into what is typical and what is possible in private company investing today.

As helpful as these documents are, they are also impenetrably dense to the entrepreneur or investor encountering them for the first time. Taken together, the NVCA model agreements contain 247 explanatory footnotes and span 199 single-spaced pages. Few entrepreneurs or investors have the time or the inclination to pore over the legal fine print in these financing documents. Instead, in connection with a financing they will typically agree to a summary-level term sheet and then will rely upon their attorneys to reduce those key terms to formal legal agreements.

There are typically five core documents in connection with a venture capital financing:

Certificate of Incorporation (often called the Charter): The Charter is a publicly filed (and publicly available) document setting forth the fundamental rights of the stockholders of a company and is generally the foundation of a company from a legal perspective.

Stock Purchase Agreement (often called the SPA): The SPA is the primary sale and purchase contract between the investors and the company and includes various representations and warranties from the company to the investors in connection with the sale of the stock.

Voting Agreement: The voting agreement describes the specific procedures concerning the election of the company's board of directors and, occasionally, certain procedures that need to be observed in connection with a sale of the company.

Investors Rights Agreement (often called the IRA): The IRA is a bit of a catch-all agreement, describing a host of rights that the investors may hold in connection with their stock purchase. Some of these rights may influence the company's day-to-day operations; other rights come into play only in the event that the company eventually conducts an IPO.

Right of First Refusal and Co-Sale Agreement: This agreement (typically shortened to the Co-Sale Agreement) describes the processes that apply in the event that an employee stockholder receives an offer by a third party to purchase his or her shares outside of the context of a sale of the company.

Before going through the most important terms in these agreements, three final explanatory notes are required.

- First, venture capital financings typically involve the sale of "preferred" stock. The difference between the preferred stock purchased by investors and the "common" stock held by founders and employees is that preferred stock contains control, governance, and economic rights not granted to the common stock.

  Preferred stock is typically divided into different series, and as a company increases in value, it will issue multiple, different series of preferred stock. A company's first series of preferred stock is often called "Series Seed" or "Series A," and then as a company matures it will issue Series B preferred stock, Series C preferred stock, and so on. The Series Seed preferred stock is often the least expensive on a per-share basis, and one of the company's goals is to sell preferred stock at progressively higher prices as the company becomes more successful and valuable. In addition to having a different price per share, each series of preferred stock can have governance and control rights that differ from the other series, and these rights will vary depending on the leverage held by the company or the investors at the time of each investment.

- Second, although the majority of venture capital financings raising at least $1 million involve the sale of preferred stock, this method is not the only way to finance a startup company. Emerging companies in the venture capital economy also raise capital through the sale of convertible promissory notes or other convertible or exchangeable financial instruments, as well as through growth capital loans from commercial banks or other lenders.

- Finally, this chapter was written from the perspective of a startup attorney practicing in Silicon Valley, and this list reflects a view of the venture capital world from that perspective.

  The chapter could rightly be accused of having a Delaware corporation focus (or bias), as nearly all the companies aspiring to obtain conventional venture capital investment are Delaware corporations. We don't have the space here to discuss at length the reasons for Delaware's dominance in this arena; however, the primary reason for Delaware's dominant position in venture capital is that Delaware has long maintained a highly specialized court to hear corporate governance disputes and to interpret its corporate law, the Delaware Court of Chancery. This structure means that the outcome of governance disputes in Delaware corporations may be more predictable than governance disputes involving companies formed in other jurisdictions. This predictability permits entrepreneurs and investors, advised by attorneys familiar with Delaware corporate law, to move forward with greater certainty and confidence.

THE MOST IMPORTANT TERMS IN A VENTURE CAPITAL FINANCING

1. *Understand the protective provisions held by the investors.* Entrepreneurs often focus intently on the imputed valuation of their company in connection with a venture capital financing. That's understandable. Generating a high "pre-money" valuation feels a bit like a scorecard, confirming success. But a company's valuation is far from the most important term, especially for a first-time entrepreneur who has never before navigated the process of collaborating with venture capital investors to build a private company.

   We start with the protective provisions because these provisions are a stark reminder to an entrepreneur that choosing a venture capital investor means choosing a business partner. To put a finer point on it, after a venture capital financing, it is no longer "your" company. After a venture capital financing, control of the company is shared, and an entrepreneur ignores this sharing of control at his or her own peril.

   The protective provisions (also frequently called the "voting rights") are set forth in the charter. These provisions address a set of corporate actions for which a company needs the consent of a large percentage of the preferred stock in order to take such action. The list of actions requiring approval varies from deal to deal, but this list almost always includes getting preferred stock approval before the company can (a) sell a new series of preferred stock or (b) conduct a merger or a sale of the company.

   Read that last sentence again. By selling his or her first series of preferred stock, an entrepreneur agrees that he or she will not sell the company without the approval of the holders of the bulk of the shares held by the investors, nor will he or she conduct another financing. You don't need to use too much imagination to see how this structure could create problems in the future.

   The shared control structure created by the protective provisions means they are more important than getting the highest possible valuation when selling stock in a financing. Getting a high valuation might be a superficial gain for the preexisting stockholders, since the sale of preferred stock at a higher price per share means the existing stockholders suffer less overall dilution of their ownership position, but a high valuation can come at a terrible cost if it means that company management will then need to deal with a difficult or uncooperative business partner in the future.

   Just as an investor is choosy in the companies in which it invests, it's important that an entrepreneur be selective and thoughtful when choosing to accept investment. Have you spoken to others who have worked with this investor, and would those entrepreneurs do the same again? Do the investor's expectations and goals for the company align with your own?

2. *Understand what level of investor approval is required for key actions*. So we've discussed that a company's management needs to work with the company's investors to approve future financings or a sale of the company. But among the investors, who needs to approve an action in order to satisfy a protective provision?

   After the company's first venture capital financing, the answer to this question is straightforward. It's usually the case that one investor will either fund 100 percent of the company's Series Seed financing or that a lead investor will set the terms for the financing and will end up holding a supermajority of the preferred stock following the closing of the transaction. In such a situation, this investor will typically call the shots wherever the financing documents call for the approval of the preferred stock, including the protective provisions discussed above.

   As the company grows and issues new series of preferred stock, it is often the case that, over time, the set of investors whose approval is required will change. For example, if a company were to complete a Series Seed financing and then a Series A financing (where, in this example, a different investor leads each round), it wouldn't be at all unusual for a company to need the approval of both the lead investors for key matters going forward.

The specific percentage of preferred stock approval required to take an action covered by a protective provision is often set to a majority of the preferred stock shares then outstanding; however, it doesn't have to be at that level. For example, if a company had two large investors, each holding 33⅓ percent of the preferred stock, and also had a number of investors holding smaller percentages, you could see a situation where the financing documents might provide that 66 percent or 60 percent of the preferred stock would be required to approve a matter. This higher threshold would ensure that a matter up for investor approval was either (a) supported by both of the company's major investors or (b) was approved by one of the major investors with substantial support from the rest of the company's investor community.

Although it's generally a good idea from the company's perspective to stay as close as possible to a simple-majority preferred stock approval standard (instead of a higher and harder to reach supermajority standard), the approval threshold itself is less important than understanding whose approval is needed in order to conduct business, since losing the support of the requisite stockholders for important amendments can grind things to a halt. There are 25 places in the NVCA forms where the documents require the approval of the relevant majority of the preferred stock in order for the company to take some action. It is imperative that a company understand the relevant approval threshold before proceeding down a particular path.

In addition to the above approvals, which require the preferred stock to vote together as a single class, investors will occasionally request "series-specific" protective provisions, especially in later-stage financings as a company approaches an IPO or a potential acquisition. A company should be especially cautious when considering these provisions, since such terms can give a single investor a degree of leverage and control that is far greater than that investor's overall ownership percentage of the company.

Sometimes series-specific provisions are very targeted to address as a specific investor concern (for example, requiring that the company get the separate approval of the Series D preferred stock in the event of a sale of the company where the Series D preferred stock doesn't at least get its money back). In other situations, series-specific approvals and protections can be quite broad (for example, requiring that the company get the separate approval of the Series D preferred stock in the event of *any* sale of the company). In either case, entrepreneurs should be cautious and think of potential speedbumps down the road before accepting such terms.

3. *Understand the investors' economic rights*: A fundamental theory underlying the preferred stock structure of venture capital investing is that in connection with a sale of the company, the investors will receive their money back prior to common stockholders receiving anything in exchange for their shares. This concept is referred to as a "liquidation preference" held by the preferred stock.

   Although the early stage venture capital investment community has largely settled on a standard form of liquidation preference, investors can and do propose investments to companies with varying liquidation preference terms. Understanding the economic impact of these modified terms will help you see that two deals that otherwise are at the same pre-money valuation can have very different exit economics for the founders and employees holding common stock and stock options.

   The standard liquidation preference in venture capital investing is called a "nonparticipating liquidation preference." The "nonparticipating" reference describes what happens to the preferred stock after its liquidation preference is fully paid out. If preferred stock is "nonparticipating," in the event of a sale of the company the preferred stock will not "participate" in payments to stockholders in excess of its liquidation preference. For example, in a company that has taken $10 million in venture capital investment and is later acquired for $15 million, the first $10 million in the acquisition would go back to the venture capitalists, then (generally speaking) the common stockholders would split the rest.

"But wait," you say. "In this example, the investors are simply getting their money back, without interest." And you'd be right. No venture capitalist is trying to simply get an investment's liquidation preference returned to his or her fund. By holding preferred stock with a nonparticipating liquidation preference, a venture capitalist has a choice in a sale of the company: It can either (a) receive its liquidation preference back (or, in a downside scenario, a fraction of that liquidation preference) or (b) it can convert its preferred stock into common stock and can share in the upside as the dollars paid to the company begin to greatly exceed the aggregate liquidation preferences of the preferred stock investors.

When an investor holds nonparticipating preferred stock, that investor will convert its preferred stock shares to common stock shares if that would yield a higher price per share than just the return of the preferred stock's liquidation preference. In my example company with $10 million in outstanding venture capital investment, should the company later be acquired for $50 million it would be quite likely that the preferred stock would receive a greater per-share payout were it to convert to common stock. Upon conversion, the liquidation preference associated with the converting preferred stock would evaporate, which would in turn increase the proceeds distributable to the common stockholders.

Now compare the above economics with "participating" preferred stock. A participating preferred stock structure is less common in venture capital transactions today, but it is still present. The presence of a participating liquidation preference in a deal may be a signal that the investor was concerned about certain risks in the deal, or that the investor had to increase its upside in order to get comfortable with the transaction. Or it simply may be a part of the investor's overall investment thesis and is a standard term that it includes in deals to drive returns to its limited partners.

If an investor holds participating preferred stock, the investor will first receive its liquidation preference and thereafter will participate alongside the common stock in the payment of any additional stockholder proceeds. Let's look again at my example company with $10 million of investment, later acquired for $15 million where the preferred stock (in this example) is all participating preferred stock. In this sale, the first $10 million would still go to the investors, but—assuming in this example that the preferred stockholders own 50 percent of the overall stock of the company—$2.5 million of remainder would be split among the preferred stockholders and $2.5 million would be split among the common stockholders, reducing the common stock payout by 50 percent relative to my earlier nonparticipating example. There would never be an inflection point where the preferred stock would convert to common stock, because participating preferred stock does not need to convert to common stock to receive an upside benefit at a sale of the company.

In addition to participating preferred stock, there is also "partially participating" preferred stock of several types, all of which yield the same fundamental result, which is to raise the inflection point at which the preferred stock will be incentivized to convert into common stock. Whether participating or partially participating, if an entrepreneur is considering a deal with a participating liquidation preference deal component, it will be important for the entrepreneur to understand the impact of this feature at the sale of the company so that he or she isn't later stuck with a nasty surprise regarding the common stockholders' exit economics.

From the perspective of this author, the three above terms are the three most important terms in a venture capital financing. Other investors, entrepreneurs, attorneys, and advisors may look at the NVCA forms, with their 247 explanatory footnotes and 199 single-space pages, and see other terms that they believe to be more crucial. But what is certain is that any entrepreneur or investor would benefit from slowing down and better understanding the meaning of the terms governing a venture capital investment. At times, these terms read like so much legalese, but these are the provisions that ultimately determine how investment returns will be shared among investors, founders, and employees.

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