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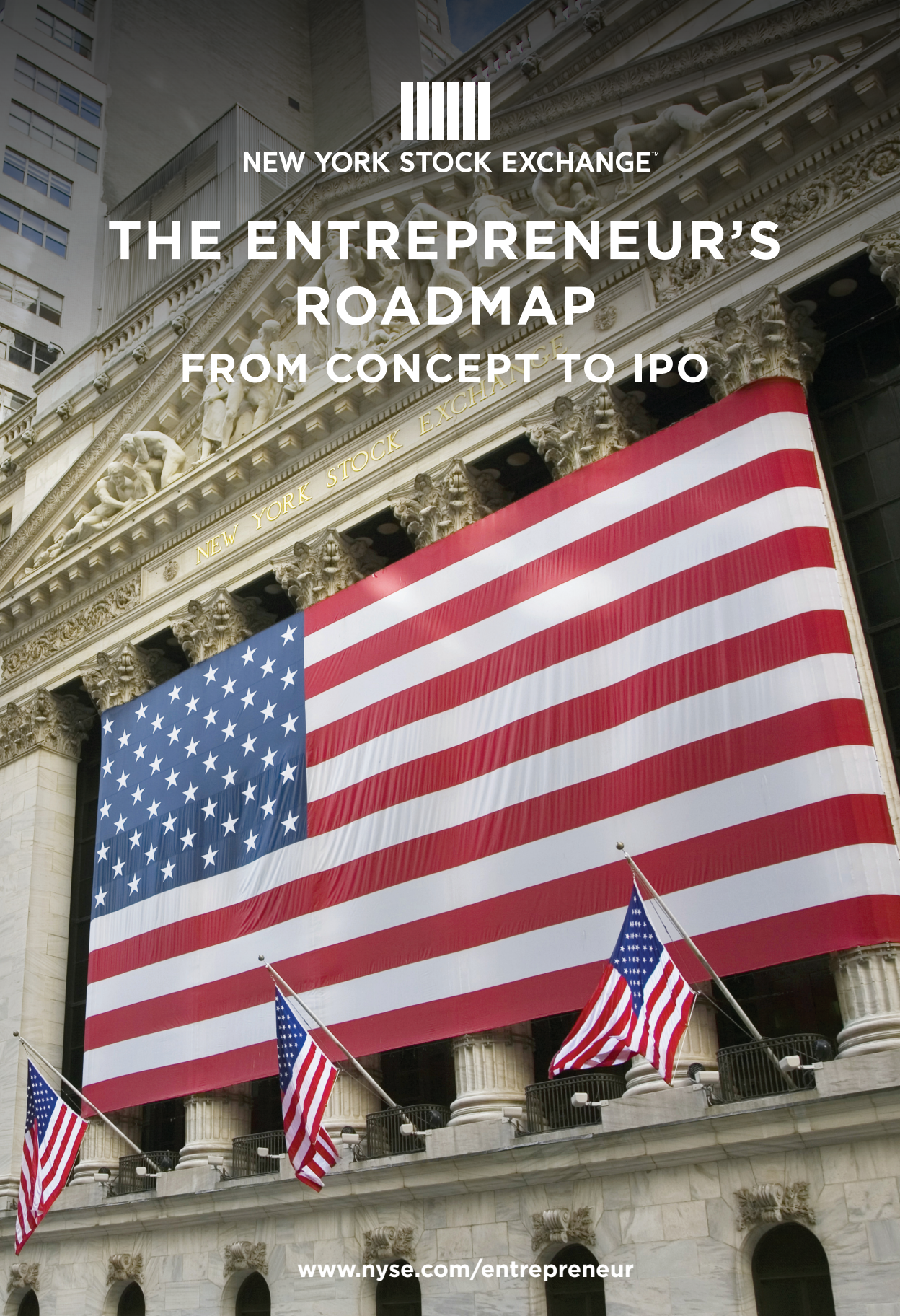

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KEY CONCERNS IN FOLLOW-ON FINANCING ROUNDS

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In taking on growth capital in a follow-on financing round, an emerging company must address the maturation of its capital structure beyond the relative simplicity found in early-stage companies. Investing larger amounts at higher valuations, later-stage venture or growth firms will have incentives that diverge from those of the company's early-stage investors, particularly with respect to growth and exit strategies. This divergence requires a careful balancing of economic and governance rights among the company's stockholders: new investors need to protect their economic interests and existing stockholders are wary of ceding flexibility on key strategic decisions.

The costs of getting this balance wrong can be steep: an emerging company can find itself, post follow-on financing, in need of unanimous approval from multiple constituencies with conflicting incentives to set and act on its strategic goals.

STRUCTURE—PRIMARY AND SECONDARY TRANSACTIONS

The threshold issue in a growth-stage investment is how the capital will be used: whether funds are added to the company's balance sheet to fund corporate growth or paid to existing stockholders in purchase of their holdings in the company. Growth-stage investment firms are significantly larger than early-stage venture funds and require a certain minimum "check size" to take on a new portfolio company, which minimum may exceed the company's need for operating capital. The specifics of the situation will dictate whether the financing is primary only (all cash is going to the balance sheet), secondary only (all cash to existing stockholders), or a combination of the two.

The primary portion of a typical growth transaction involves the sale of a newly authorized series of preferred stock, with the company providing customary representations concerning its business, financial results, and assets (including intellectual property). The preferred stock also will carry standard economic rights, such as a right to preferential payment in a liquidation.

For the secondary portion, investors will purchase either additional preferred stock, with the company using proceeds to repurchase shares from existing holders, or outstanding shares directly from existing stockholders. In this latter structure, referred to here as a "cross-purchase," the purchasing investor will receive only the economic rights already present in the shares being purchased (which, if common stock, will be minimal). Accordingly, the cross-purchase structure often occurs at a slightly discounted price per share compared to primary shares.

Regardless of the form, the following issues must be addressed in any secondary transaction:

Tax and accounting concerns: It is critical that the company's financial advisors are consulted to ensure proper tax and accounting treatment. Depending on the participants and structure, a portion of the proceeds may be treated as employment income under tax or accounting rules for sellers that are (or were) employees.

Impact on option grants: For a secondary transaction involving common stock, the company must consider the relationship of the transaction price to prior determinations of fair market value, as well as the impact on any future valuations undertaken to support the granting of stock options.

Participants: Generally, most secondary transactions involve either a limited number of sellers (typically founders or senior management) or a broader group of stockholders, potentially segregated by type of shares held or employment status (e.g., participation may be limited to current employees as an incentive tool). An offer to purchase shares from a broad group of shareholders (whether by company repurchase or a cross-purchase) may be subject to the tender offer rules of Section 14(e) of the Securities Exchange Act of 1934. Failure to comply with such rules could result in sellers have a right to unwind the transaction after the company's value has significantly increased.

Disclosure: If stockholders other than the company's management team and investors represented on the board of directors are eligible to participate, potential sellers should be given sufficient information about the company (including financial reports) to enable a fully informed investment decision.

Liability issues. In a typical primary transaction, the company makes representations concerning its business and operations, and investors will be able to bring a breach claim if those representations prove untrue (although it practice, such claims are rare). While selling stockholders will be required to represent to ownership of their shares and right to sell, whether they should additionally be liable in the event of a breach of commercially focused representations is open to negotiation. Recent market trends have generally exempted sellers from such liability in transactions where the secondary portion represents only a small fraction of the total investment.

Other concerns: Other items to consider include: exemptions from the Securities Act of 1933, compliance with the state and federal antifraud protections, and the applicability of transfer restrictions (and other contractual rights and obligations) to the secondary sale and, in the case of a cross-purchase, afterwards.

ECONOMICS AND PATHS TO LIQUIDITY

The economic terms of a growth-stage financing are typically consistent with earlier stage financings; in fact, those earlier terms generally will serve as the baseline for the negotiation of the new round. However, despite the similarity of terms, differing investment valuations and amounts create the potential for misalignment of interests between earlier-stage and later-stage investors with regard to the various paths to liquidity.

MERGERS AND ACQUISITIONS

The Liquidation Waterfall

The liquidation preferences of preferred stock result in a waterfall governing the allocation of proceeds of a sale of the company among the company's stockholders. As shown in the example below, conventional "non-participating" preferred stock will have a right to be repaid its purchase price at lower relative valuations or participate on the basis of overall ownership percentage at higher relative valuations.

A simplified example is below, assuming a $6,000,000 Series A round shared by two venture capital firms at a $15,000,000 post-money valuation and a $25,000,000 Series B round at a $100,000,000 post-money valuation. The Series B round is primary only, with a $20,000,000 investment from the new investor and each of the Series A investors adding $2,500,000.

TABLE 1A Base Example

	Series B Preferred ($5/share)	Series A Preferred ($1/share)	Common Stock	Fully Diluted Ownership
Founder			4,500,000	22.5%
CEO			2,000,000	10%
VC1	500,000	3,000,000		17.5%
VC2	500,000	3,000,000		17.5%
New investor	4,000,000			20%
Employee option pool			2,500,000	12.5%
Total shares	5,000,000	6,000,000	9,000,000	100%

Post-financing, the Series A Preferred and the Series B Preferred have a total liquidation preference of $31,000,000, meaning that no payments will be made on the common stock unless the sale price for the company exceeds that amount. At sale prices between $40,000,000 and $100,000,000, the Series A will act as if converted to common stock and share in the remainder after the Series B preference is paid, and at sale prices above $100,000,000, the Series B will act as if converted to common as well, and all shareholders will be paid based on their fully diluted ownership.

Flat Exits

One key concern for new investors in a follow-on round is a sale of the company at a price at or close to the valuation of their investment, as this would result in a return of their capital without increase but a significant gain for the existing stockholders. The new

TABLE 1B

	B Preference	A Preference	As-Converted	Total
Founder			$22,500,000	$22,500,000
CEO			$10,000,000	$10,000,000
VC1	$2,500,000	$0	$15,000,000	$17,500,000
VC2	$2,500,000	$0	$15,000,000	$17,500,000
New investor	$20,000,000			$20,000,000
Employee option pool			$12,500,000	$12,500,000

investor will have effectively provided an interest-free loan, giving the company time and funds to locate a sale opportunity without increasing the company's valuation above the follow-on round.

In the example above, if the company were sold for $100,000,000 after the Series B investment, the proceeds would be distributed per Table 1B.

The new Series B investor receives their $20,000,000 investment back with no gain, while each of the Series A investors has realized $17,500,000 on an aggregate investment of $5,500,000.

To address this concern, the new investor may push for an approval right over any sale of the company. However, a blanket approval would allow the new investor to reject future sales even where the concern regarding a flat exit did not apply—the new investors' higher valuation creates a risk/reward misalignment with the new investor seeking continued growth beyond what may satisfy the existing stockholders in order to generate returns.

One conventional compromise is for the new investor to have approval rights over a sale only if the investor fails to receive a negotiated minimum return, for example 1.5x or 2x the investment amount (typically in liquid consideration, such as cash or publicly traded securities). This blocking right may also be time-limited, possibly applying only for two to three years after the investment, preserving longer term flexibility for the company.

Protecting the Liquidation Preference

The mechanics of preferred stock can create further misalignment among early and later investors. Preferred stock will be convertible into common stock on an initial public offering (as discussed below) or on the voluntary election of the preferred stockholders. The terms of the financing round will determine whether such an election can be made by the holders of all preferred stock voting together, or only on a series by series basis (e.g., the Series B holders must elect to convert the Series B preferred stock).

In the context of the example, should the preferred stock convert to common stock upon the election of the Series A Preferred and Series B Preferred shares voting together, or should the Series B Preferred shares only be converted on election of the holders of such Series B

shares? Analyzing a low-value sale demonstrates the issue.

The tables below compare the results of a company sale at $40,000,000 if liquidation preferences were paid on the Series A Preferred and the Series B Preferred (top table) and if all preferred was first converted to common (bottom table).

Note that the as-converted distribution results in the early investors (whose 7,000,000 shares constitute the majority of 11,000,000 shares of preferred stock) increasing their payouts substantially at the expense of the new investor. Accordingly, the two early investors will have the incentive to trigger the conversion of all preferred stock into common, and the new investor will seek protection by requiring its approval for any such conversion of the Series B Preferred.

Running counter to the new investor's desire to avoid circumvention of their liquidation preference (whether by conversion to common or through exploitation of other

TABLE 2A Proceeds Distribution if Preferences Paid

	B Preference	A Preference	As-Converted	Total
Founder			$4,500,000	$4,500,000
CEO			$2,000,000	$2,000,000
VC1	$2,500,000	$3,000,000	$0	$5,500,000
VC2	$2,500,000	$3,000,000	$0	$5,500,000
New investor	$20,000,000		$0	$20,000,000
Employee option pool			$2,500,000	$2,500,000

At a $100,000,000 sale, the Series B shares will receive the amount as preference or if treated as converting to common. For the purposes of the example, they are shown as receiving preference.

TABLE 2B Proceeds Distributions if all Preferred Converted to Common

	B Preference	A Preference	As-Converted	Total
Founder			$9,000,000	$9,000,000
CEO			$4,000,000	$4,000,000
VC1	$0	$0	$7,000,000	$7,000,000
VC2	$0	$0	$7,000,000	$7,000,000
New investor	$0	$0	$8,000,000	$8,000,000
Employee option pool			$5,000,000	$5,000,000

provisions of venture financing documents) is the company's wish for flexibility in a future recapitalization transaction, where modifications to the preferred's economic rights may be a precondition to additional investment. Needing each investor to separately approve such changes could vastly increase the difficulty in completing such a transaction

INITIAL PUBLIC OFFERING

When an emerging company completes an IPO, all preferred stock will convert to common stock; a general prerequisite for listing is that only common stock be outstanding. The company's governing agreements will provide for this conversion to occur without any need for stockholder approval, subject to certain negotiated minimum requirements: characteristics of the offering (e.g., a firm commitment underwritten offering on specified exchanges) and a minimum offering size and a per-share price (usually expressed as a multiple of the price paid by the new investor). A proposed offering that fails to satisfy such criteria would require the holders of preferred stock to voluntarily elect such a conversion, meaning that new investors who have negotiated for an approval right on conversion of their preferred stock can effectively block an IPO that doesn't satisfy the specified requirements.

The specifics of these minimum requirements are typically heavily negotiated, particularly in later stage rounds where an IPO at a lower valuation than the financing is feasible. Without any such requirements, the new investor could see preferred stock with $100,000,000 in liquidation preference converted into $80,000,000 worth of common stock at the closing of the IPO. The company will seek to preserve flexibility in the event that the board of directors determines an IPO at such lower price is the best path for the company.

A conventional solution to such competing demands is an "IPO ratchet," allowing for the preferred stock to be converted into common upon the closing of an IPO even in the absence of achieving a minimum offering price, with an adjustment made to the number of shares of common stock issued in such conversion to ensure a minimum value for the investors. In the example from the prior paragraph, the holders of preferred stock with $100,000,000 in liquidation preference would receive additional shares of common stock so that the total value of the shares received by the investor, based on the IPO price, would be at least $100,000,000 (or potentially more in the event that a premium, such as 1.5x or 2x, had been agreed upon).

OTHER LIQUIDITY TRANSACTIONS

Secondary Sales

Investors in emerging companies have historically been permitted to engage in secondary sales of their shares, although only companies for which an IPO was seen as a near-term inevitability will trigger genuine demand for private shares. However, such companies have recently begun to take dramatic steps to prohibit trading in private shares, including blanket prohibitions of secondary sales without board approval.

Redemption Rights

A final path to liquidity is the right of investors to require the company to redeem their shares after a fixed period. Although the actual exercise of redemption rights is exceedingly rare (and subject to a number of limitations imposed by corporate law), such rights can be used as leverage to encourage a sale of the company in circumstances where management might otherwise prefer the status quo. Seniority of redemption must be addressed in a follow-on round, and it is typical to require the new investors' approval for any redemption of earlier issued preferred stock so long as the new investors' shares remain outstanding.

GOVERNANCE AND CONTROL TERMS

BOARD COMPOSITION

New investors will typically desire a seat on the company's board, which may require a balancing of investor, management, and independent representation on the board, and may cause a

shift from a founder controlled board to one controlled by the investors.

BLOCKING RIGHTS

In all but the most unusual cases, emerging companies with significant investor capital will be subject to an investor consent requirement prior to undertaking a specified set of actions (such as new rounds of financing, sale of the company, etc.), with the particular actions (and exceptions) varying by situation. Typically, the key issues in a follow-on round are less about which actions require such approval than which particular investors are required to satisfy such approval, and whether there will be a subset of actions that require the approval of the new investor separately from the earlier investors.

Best practice for an emerging company is that the general set of preferred stockholder approval items requires a nonunanimous pooled investor vote to prevent any single investor from exercising exclusive control over key strategic decisions. Such pooled voting, at a minimum, requires the approval of the holders of a majority of all preferred stock, voting together. In the example above, each of VC1 and VC2 hold 3.5 million shares of preferred stock and the new investor holds 4 million shares; a majority of the 11 million preferred shares could be achieved by any two of these three investors. What threshold is ultimately implemented will depend on the specifics of the company's capitalization and the relative leverage of the parties.

Series-Specific Votes

Because of the potential for a growth round to misalign investor incentives, new investors typically seek some exceptions to general pooled voting. In the example above, allowing VC1 and VC2 to vote their majority of preferred stock to benefit the holders of Series A Preferred at the expense of the holders of Series B Preferred is unlikely to be acceptable to the new investor. The following are a few areas where new investors might seek voting rights under their exclusive control.

Senior capital: To protect their liquidation preference, new investors may negotiate for a right to block the company from incurring significant payment obligations that would be senior or of equal priority to their rights, whether in the form of debt or a new series of preferred stock.

Adverse/disparate treatment: Pooled voting leaves open the possibility that one series of preferred stock could be subject to adverse treatment as a result of changes to terms approved by a pooled vote of the preferred shares. Delaware corporate law affords some protections against adverse changes that "single out" a series of preferred stock, but such a provision may not adequately protect the new investor's rights in all circumstances. New investors will seek to require their approval for changes that adversely impact their shares, regardless of whether the other shares of preferred stock are affected. The specific language to address this concern is typically highly negotiated.

Affiliate transactions: A new investor may wish to ensure that a transaction between the company and its officers, directors, or major existing stockholders not be subject solely to a pooled vote. The risks presented by such a transaction are mitigated by the fiduciary duties of the members of the company's board, but investors often prefer an explicit approval right.

Increasing shares: To ensure continued benefit from the aforementioned Delaware law protections, new investors will usually seek to maintain the majority of the shares of their series of preferred stock by prohibiting the company from authorizing more shares of such series without the new investors' approval.

Dividends/repurchases: New investors may seek a separate approval right over transactions that would cause the company's cash to be paid to stockholders, as dividends, repurchases, or otherwise.

OTHER TERMS AND CONSIDERATIONS

Emerging companies can also anticipate that the level of legal due diligence performed in a follow-on financing will be substantially more involved than earlier rounds, given the larger investment

amount. As a follow-on round is generally correlated with the company's evolution from an idea to a successfully scaling business, new investors will be carefully reviewing corporate files to ensure that the company has been properly documenting its employment and commercial relationships to ensure ownership and control of intellectual property rights, that strategic relationships and customer contracts pass close examination, and that there are no ambiguities with respect to equity ownership. International operations and regulatory matters will come under scrutiny as well.

As required in all private financing transactions, care must be taken to comply with federal and state securities laws. Additionally, the federal antitrust provisions of the Hart-Scott-Rodino (HSR) Act may affect larger financing transactions. Significant foreign operations could likewise result in the need for analogous consideration by foreign governments.

CONCLUSION

Managed properly, growth financing rounds can be key building blocks for an emerging company's future success. If executed poorly, the company can be left subject to conflicting interests and overlapping blocking rights that impair its flexibility. Such flexibility is critical when decisions about a sale of the business are under consideration or in the event the company hits the proverbial "bump in the road" and needs to act quickly to get back on track.

A final reminder: this article was written to outline the key concerns and present issues for consideration. Ultimately, the "right" solutions to the legal and economic issues that can arise in a follow-on financing round will be heavily influenced by the specifics of the situation. Emerging companies are advised to engage and seek strategic advice from experienced counsel.

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