CHAPTER 11

Venture Capital Financing

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Scope Note

This chapter covers the protocols and procedures attendant to acquiring venture capital financing. It explains the lawyer's role in representing the enterprise and discusses the terms of investment securities and the investment agreement, ancillary agreements, and necessary documentation.

§ 11.1 INTRODUCTION

A key element in the attainment of a successful relationship between a new or growing business enterprise and its venture capital investors is the knowledgeable crafting of the investment's legal structure. Counsel to the enterprise plays a crucial role in this investment process.

§ 11.2 BACKGROUND

There are many sources of financing for new or growing businesses:

- personal resources of the founder;
- family, friends, and members of the founder's personal network;
- wealthy individuals, either singly or as part of "angel" or "seed" financing groups;
- government and university grants;
- banks;
- asset-based lenders;
- large corporations willing to provide research, development, or equity financing in exchange for equity or rights to products;
- quasi-governmental agencies and entities; and
- venture capital funds.

The term "venture capital" is sometimes broadly used to include any noncontrol equity or debt investment that the investor perceives as risky because the company in which the investment is made is just beginning, not well established, or has not been profitable for long. Consequently, one hears of equipment lease companies that specialize in venture deals and individuals who refer to themselves as private venture capitalists. Organized groups of "angel" or "seed" investors often structure investments that look much like investments by professional venture capital firms. In addition, some venture capital funds that historically financed only new privately held companies now invest in public companies and participate in leveraged and management buyouts, further extending the meaning of venture capital. The focus of this chapter is the financing of privately held companies by traditional venture capital funds.

A typical venture capital fund is a professionally managed, limited pool of funds that is organized, for a number of U.S. and non-U.S. tax reasons, as a limited partnership with a defined life, often ten years. Investors in venture capital funds often include insurance and industrial companies, public and private pension funds, universities and endowments, family offices, and wealthy individuals. The financial goal of these funds is for the return on investment for the fund as a whole to exceed 15 to 20 percent per year. Given that some investments fail, the planned rate of return for each investment in a portfolio company usually exceeds 15 to 20 percent by a substantial margin and is reflected in the pricing decision for each investment. In general, venture capitalists must achieve the financial goals of each investment within five to seven years after the initial investment in an early-stage company because of the investment cycle and life of the venture capital fund. The venture capitalists must provide a substantial return to the investors in the venture capital fund if the venture capitalists hope to raise a subsequent fund to continue their venture capital investing business.

The only business activities of venture capital funds are investing in the securities of companies that they believe meet the financial objectives of the fund and assisting, typically fairly actively, those companies in achieving their business objectives. Historically, these funds have preferred investments in high- or new-technology companies because these companies (if successful) tend to grow large and become profitable quickly, capture a significant portion of new or existing markets, and provide liquidity for investors through public offerings or mergers. In 2022, venture capital firms invested approximately $238 billion, with software companies capturing about 40 percent of those dollars and health-care-related deals capturing about 20 percent of those dollars. Combined, the software, health-care, and goods and services categories accounted for 90 percent of deals in 2022. *National Venture Capital Association Yearbook* (2023 ed.). While venture capital funds traditionally have focused on investments in high- or new-technology companies, an increasing number of venture capital funds have determined to specialize in more narrowly defined areas such as gaming, cloud computing, commercial products and services, consumer products and services, health-care devices and services, pharmaceuticals, materials, biotechnology, clean technology (e.g., renewable energy, recycling, and conservation), artificial intelligence, financial technology, telecommunications, Internet infrastructure, computer networking, and wireless communications. Put simply, venture capital funds target any segment of the economy where an acceptable rate of return can be achieved.

Additionally, venture capital funds are focusing on many stages of a company's financing life cycle. In 2022, 39 percent of overall deals were for angel or seed rounds, 30 percent were for early-stage rounds, 26 percent were for late-stage rounds, and 5 percent were for venture-growth rounds. *National Venture Capital Association Yearbook* (2023 ed.). Traditionally, venture capital funds invest as early in a company's history as possible, assisting the company in developing a successful business, and planning to realize their gains through the growth in the equity value of the company at the time the company is sold or undertakes its first public offering of stock. Venture capitalists are most interested in companies they believe show potential for significant rapid growth; they are disinclined to invest in capital-intensive, traditional heavy industry.

Massachusetts has been a major center of venture capital activity for at least the past sixty-five years. In 2022, the most recent year for which data is available, sixty-two venture capital firms based in Massachusetts raised an aggregate of more than $15.6 billion. Only firms based in California and New York raised more. Approximately 60 percent of the venture capital deals in 2022 in the United States occurred in five states—California, Massachusetts, New York, Texas, and Florida. Companies based in Massachusetts received approximately $21.3 billion in venture capital investments in 2022. *National Venture Capital Association Yearbook* (2023 ed.). Only California and New York companies received more. For many years the goal of venture capital funds was to match the success of American Research and Development, one of the first professionally managed venture capital funds in Massachusetts, which purchased approximately 70 percent of Digital Equipment Corporation for approximately $70,000 in 1957.

The year 2022 saw the most fund-raising by venture capital funds in modern history, with nearly $163 billion raised across 784 funds, and venture capital funds ended 2022 with a record high amount of approximately $312 billion in capital waiting to be invested. In 2022, while most venture capital investment continued to be directed to the commercial hot spots of Boston, New York City, and the Bay Area, the year saw deals close in every state, Puerto Rico, and the District of Columbia. Notably, Illinois saw the largest venture capital deal of 2022, and North Carolina, Pennsylvania, and Texas all ranked in the top ten. For the past five years, the South, mid-Atlantic, and Mountain West have all grown at rates above the national average. *National Venture Capital Association Yearbook* (2023 ed.).

By the end of 2022, the seven largest publicly traded companies by market capitalization in the United States—Apple ($2.2 trillion), Microsoft ($1.9 trillion), Alphabet ($1.2 trillion), Amazon ($856.9 billion), Tesla ($389 billion), Meta ($315.6 billion), and NVIDIA ($612.2 billion)—were all companies that were venture capital–backed in their early years. *National Venture Capital Association Yearbook* (2023 ed.). According to research that analyzed the impact venture-backed companies had on the economy between 1978 and 2020, venture-backed companies account for 41 percent of total U.S. market capitalization, 62 percent of research and development spending, and 48 percent of patent value. When the researchers narrowed their dataset to companies founded after 1968 that went public after 1978 (corresponding to the advent of the modern venture capital industry), their results were even more stark. Venture-backed companies accounted for half of all companies in that time period by number, but represented three-quarters by value and generated 92 percent of research and development spending and 93 percent of patent value. Will Gornall & Ilya A. Strebulaev, "The Economic Impact of Venture Capital: Evidence from Public Companies," *Social Science Research Network* (July 8, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.

§ 11.3 ROLE OF COMPANY COUNSEL

Company counsel plays a critical role in facilitating the venture investing process. Entrepreneurs frequently have little or no prior experience with venture capital transactions and frequently feel themselves ill-prepared to deal with the extensive and well-defined industry jargon, the intensive due diligence, the amount of paper and time involved in completing a transaction, and the governance features on which venture capitalists often insist. Venture capital investors by definition have extensive experience in all these areas, which often puts entrepreneurs at a disadvantage. Company counsel is responsible for helping the company understand the various concerns and expectations of the parties. Although the terms of each venture investment are different and reflect the different facts of the particular situation, the general parameters of venture investments and limits of what is considered to be reasonable negotiation and compromise of most issues are relatively well established and should be explained to the company by its counsel. Knowing which rights are not negotiable items for venture capital investors in most transactions, and why, as well as the “market” parameters of rights that are open for discussion, can often make the entire investment process more productive and likely to succeed. This is particularly important in venture capital, where a productive working relationship between the entrepreneur and the company’s venture capital investors is critical to the company’s future success.

§ 11.3.1 Concerns of the Venture Capital Fund

The typical concerns of a venture capital investor in structuring an investment include

- ensuring a reasonable reward from the investment based on the risk and stage of development of the company, future liquidity if the company is successful or stagnates, and protection of some value if the enterprise is unsuccessful;
- obtaining sufficient influence on the development of the business and, in situations in which performance is below expectations, over a change in management;
- ensuring that management and key employees have a stake sufficient to provide adequate incentives; and
- minimizing taxes to the investor, which may require the company to adopt the corporate form to avoid taxes on “unrelated business income” for certain tax-exempt investors in the venture capital fund and U.S. trade or business income for non-U.S. investors in the venture capital fund.

Venture capital funds also want to own enough of the company and have enough capital invested to justify the commitment they make to assist the company in reaching its goals. The general, but frequently modified, rule of thumb has been that the venture capital fund that makes the first venture investment in an early-stage company takes approximately 40 percent of the company regardless of the amount invested. Further, a venture capitalist may be required by its investors to obtain certain rights (e.g., “management rights” if the fund has Employee Retirement Income Security Act (ERISA) investors, such as private pension funds) and may seek to obtain downside protection in its investments. The typical venture capital fund also has certain requirements that arise from its organization as a limited partnership and established expectations of investors in venture capital funds. For example, after a portfolio company has its initial public offering, the fund often distributes the securities of the portfolio company to its investors to allow the separate investors to decide to hold or sell the securities. This in turn requires the fund, during negotiation, to insist that certain of its rights be transferable to its investors if the securities are distributed.

§ 11.3.2 Concerns of the Entrepreneur

The typical concerns of an entrepreneur in structuring an investment include

- retaining overall operating and strategic control of the business,
- obtaining adequate working capital to enable the business to develop as envisioned,
- a meaningful financial interest in the company and a means for realizing the value of that interest,
- minimization of tax exposure resulting from the purchase of “cheap stock,” and
- obtaining substantive contributions to the business from the venture capitalists in addition to their investment dollars.

§ 11.3.3 Common Concerns

Common interests include sufficient flexibility in structure to allow for additional investments as the enterprise develops; incentives for future management and retention of equity by the company if management leaves; retention and attraction (if necessary) of key employees through equity participation; and a balance sheet that is attractive to both business partners and lenders.

§ 11.3.4 Effect of Targeted Capital Gains Taxation

Section 1202 of the Internal Revenue Code of 1986, as amended, creates tax benefits, in the form of a reduced rate of federal income taxation on certain stock sales gain. Indeed, for stock issued after September 27, 2010, 100 percent of the gain on Section 1202 stock is, subject to certain limitations based on dollar amounts and/or adjusted basis calculations, potentially excluded from both the regular tax and the alternative minimum tax. The benefits may be available to both entrepreneurs and investors who are individuals (with special provisions applicable to stock held through certain pass-through entities), provided they acquire their stock from the issuer after August 10, 1993, and hold that stock for more than five years. The benefits of I.R.C. § 1202 generally are available with respect to investments in corporations that

- hold assets that have an aggregate tax basis of $50 million or less immediately after the investment and at all times between August 10, 1993, and the time the investment is made; and
- are not engaged in service-related businesses, finance-related businesses, mining, farming, or hospitality-related businesses.

In order to ensure that the relevant stockholders remain eligible for the capital gains benefits of I.R.C. § 1202, however, the issuing corporation must satisfy numerous requirements during the period such stockholders hold their stock. In particular, certain redemptions by the corporation of its stock will disqualify other stock issued during the two-year periods before and after that redemption. Satisfying this and other statutory requirements may not be consistent with the corporation's business plan. For that reason, investors that are unable to obtain any benefits under I.R.C. § 1202 (such as corporations and tax-exempt institutions, including those that acquire their stock through participation in venture capital partnerships) generally will not be interested in allowing the corporation to adopt any course of action that might reduce those investors' economic returns solely in order to maintain the tax-qualified status of stock held by the founders or by other investors who are individuals.

The alternative minimum tax provisions of the Internal Revenue Code generally reduce the tax benefits of I.R.C. § 1202 for stock issued before September 27, 2010.

In addition to the favorable tax treatment potentially afforded by I.R.C. § 1202, reinvestment of the sales proceeds of certain stock in other stock of the type that would qualify under I.R.C. § 1202 can often be done on a tax-free basis. I.R.C. § 1045.

§ 11.3.5 First Duty Is to the Company

Company counsel almost always needs to explain to the inexperienced entrepreneur that, as company counsel, the first duty of the lawyer is to the welfare of the company as a whole. Consequently, while company counsel ordinarily is concerned with the protection and welfare of the founders of the company in negotiating reasonable stock vesting rights and similar matters, there may be instances when founders should have separate counsel. In practice, however, company counsel generally is engaged in a balancing act and tries to achieve a reasonable outcome for all parties. There are times when company counsel believes that only counsel is focusing primarily on the company itself.

§ 11.4 PRELIMINARY CONTACTS WITH VENTURE CAPITALISTS

Prior to approaching a venture capitalist, an entrepreneur should identify the venture capital funds most likely to invest in the enterprise. Factors that an entrepreneur may use in determining whether to approach a venture capitalist include whether

- the fund typically invests in the same geographic area as the enterprise,
- the fund typically invests in enterprises at the company's particular stage of development,
- the amount sought falls within the fund's limits regarding size of investment,
- the investor has a preference for or against investing in the company's industry, and
- the venture capitalist is typically a lead or passive investor.

The company and its counsel typically consult to determine a preliminary list of potential venture capital investors. In addition, the company's accountants, bankers, and other advisors can sometimes assist the company in identifying appropriate venture capital investors.

Once potential venture capital investors are identified, the initial contacts typically focus on creating sufficient interest in the potential investors to cause them to read the business plan. The principal purpose of the business plan, however, is to get a meeting with the potential investor, not sell securities in the enterprise. After interest is established, the discussions focus more on due diligence on the business and the management team, the valuation of the business, and the level of funding needed. This courting process may take many weeks or months.

The company should understand that many venture capitalists do not enter into agreements requiring them to keep information disclosed to them confidential or limiting the use of any such information solely to the venture capitalist's evaluation of the company. Thus, the business plan and other information disclosed to the potential investors should be sufficient to permit them to make an investment decision but should not disclose operative details of trade secrets and other proprietary information. In certain circumstances, however, a venture capitalist may retain a consultant to assist in evaluating the company's business or technology. The company should enter into a confidentiality and nonuse agreement with the consultant to ensure that the confidentiality of any information disclosed is protected and that the consultant cannot use that information for any purpose other than evaluating the business or technology for the venture capitalist.

§ 11.5 PRELIMINARY NEGOTIATIONS AND THE TERM SHEET

After the venture capital fund has preliminarily determined to make an investment, the initial negotiations of the terms of the investment and the other matters governing the future relations between the parties focus on the term sheet. The term sheet (sometimes called a letter of intent or commitment letter) represents the handshake "agreement" between the venture capital investor and the company, which is typically intended to be nonbinding. Whatever the form, the term sheet is intended to accomplish the following purposes:

- to reflect the initial agreed-on valuation of the business and to quantify the proposed allocation of that value between the entrepreneurs/management and venture capital investors;
- to summarize key financial and legal terms of the transaction that serve as the basis for preparing definitive legal documents;
- to identify any significant business events, such as obtaining a specified contract or imposing forfeiture restrictions on equity owned by the entrepreneurs/management, that must occur before an investment is made; and
- on occasion, to impose enforceable legal obligations on the parties, such as requiring payment of expenses if the investment does not close, or prohibiting negotiations with other parties pending the completion or abandonment of the transaction.

Above all, the term sheet should be used to elicit the concerns of both parties that, if unaddressed and unresolved, might later develop into "deal killers." For example, if the venture capitalist intends to require that the founders submit their stock ownership in the enterprise to buy-back or forfeiture restrictions in the event they sever employment, such a condition should be covered in the term sheet, because it is a topic about which the founders are especially sensitive. Similarly sensitive topics include the percentage ownership to be retained by the founders, the composition of the board of directors, and matters relating to the terms of employment of the founders. Company counsel often finds it necessary to explain to the founders (particularly those who have not had a great deal of prior business experience) that ownership of a majority of the stock of the company does not necessarily determine who controls the company. If an investment deal is perceived in the venture capital community to be a "hot" deal, the entrepreneur may receive a short term sheet that contains only noncontroversial or entrepreneur and company favorable terms. In such an event, company counsel should explain to the founders that the overall goal of the venture capital investor in submitting such a short term sheet is often to get the founder to sign it, and therefore become subject to the legally binding prohibition on negotiations with other parties. This leaves any discussion of controversial or potentially "deal killer" terms to be worked out at a later date when the venture capital investor feels more confident in its good working relationship with the entrepreneur and exclusive negotiating position. The time for the entrepreneur to bring up issues that are sensitive or otherwise important to the entrepreneur is prior to signing a term sheet with one venture capital fund, not after.

A term sheet is particularly valuable for the entrepreneur/manager who has never seen venture capital investment terms. For the person who is relatively inexperienced in financing transactions, a large number of new concepts are being introduced. By contrast, the venture capitalist is usually experienced and familiar with numerous levels of permutations on possible terms. The term sheet is particularly useful in bridging these differences in background knowledge and experience.

The term sheet sets forth the type of security in which the venture capital fund will invest and certain other key terms of the transaction. The term sheet also typically states that the definitive investment agreement contains customary or appropriate covenants, representations, warranties, and conditions to closing. The following sections of this chapter discuss the terms of typical investment securities involved in venture capital financings and the customary covenants (including registration rights and right of first refusal provisions), representations, warranties, and conditions to closing.

§ 11.6 TERMS OF INVESTMENT SECURITIES

Selection of the appropriate investment security for a specific transaction depends on the relative importance to the venture capital investor and the entrepreneur of a number of factors, including

- the level of risk of the venture,
- the investment objectives of the investors,
- the capital requirements of the company,
- the relative interests and contributions of other security holders,
- the degree to which management control by the investors is desirable, and
- the liquidity of the securities.

Among the securities commonly acquired by venture capital funds are convertible preferred stock, convertible debt securities, and debt securities coupled with common stock or common stock purchase warrants.

Generally, the venture capital investor prefers to invest in a senior security that is convertible into, or carries rights to purchase, common stock. A senior security with an equity feature affords the investor downside protection, in terms of the opportunity to recover the investment on a priority basis through redemption, repayment, or liquidation preferences, with the upside potential of a liquid equity security traded at significantly appreciated values in the public market. Detailed discussion of the relative merits and disadvantages of the various types of investment securities is beyond the scope of this chapter. Described in the following sections, however, are certain of the principal provisions of typical preferred stock and debt securities used in venture capital financings.

§ 11.6.1 Principal Terms of Preferred Stock

Preferred stock is the investment security most frequently used in venture capital financings because of the flexibility it offers the company and the investor in tailoring the critical issues of the investment—principally management control and recovery of or return on investment. Typically, the preferred stock is convertible into common stock and provides liquidation and redemption preferences designed to enable the venture capital investor to recoup its investment if the enterprise fails to achieve its anticipated success. Convertible preferred stock provisions should address the following major issues.

(a) *Dividends*

"Plain vanilla" convertible preferred stock traditionally does not carry mandatory dividend rights. Instead, such preferred stock participates with the common stock to the extent dividends (other than in shares of common stock or securities convertible into common stock) are declared. If an investor desires dividends or requires a current yield, the preferred stock may provide for dividends on a cumulative or noncumulative basis. Regional differences also play a role, with current pay or accumulating dividends less common in deals sponsored by West Coast venture capital firms and more common in deals sponsored by East Coast venture capital firms. Regardless of the terms of the preferred stock, most state corporate laws permit payment of dividends only when and if declared by the board of directors of the company, and then only if the company is profitable or has an adequate surplus. Consequently, cash flow considerations affect the ability of startup enterprises and many other enterprises to pay dividends. Dividend provisions typically also play a role in determining the amounts of the liquidation preference and redemption price of the preferred stock.

(b) *Liquidation*

The preferred stock typically has a preference over the common stock to the assets of the corporation in a liquidation. The concept of a "liquidation," including the types of transactions that will constitute a "liquidation" of the company, are defined in the company's charter documents. Usually a liquidation is defined to include not only the commonly understood transactions of the liquidation or dissolution of the company, but also a merger or sale of the company or a sale of substantially all its assets. In short, liquidation is usually defined to include any type of an "exit" other than an initial public offering. The liquidation preference payable to the preferred stock typically equals the original purchase price of the security plus any accrued and unpaid dividends. Preferred stock may also have rights to participate pari passu with the common stock in the assets or proceeds of the corporation remaining after the liquidation preference has been distributed (so-called participating preferred stock). Increases (premiums) in liquidation preferences are rare and may trigger constructive dividends to the investors under I.R.C. § 305. These constructive dividends are often not an issue with startup companies because such companies usually do not have profits for many years, and without such profits there cannot be a taxable dividend.

(c) *Voting Rights*

Convertible preferred stock issued in venture capital transactions often votes with the common stock on most matters and is entitled to one vote for each share of common stock into which the preferred stock may be converted. In addition, the holders of convertible preferred stock, voting separately as a class, usually have the specific right to veto certain corporate transactions affecting the convertible preferred stock (such as the issuance of senior securities; mergers, acquisitions, and sales of assets; and amendment of stock terms or charter provisions). Other preferential voting rights may include a class vote for election of directors or extraordinary voting rights to elect a majority of the board of directors upon a breach of the terms of the convertible preferred stock (such as a failure to pay dividends or make mandatory redemptions, a default in the performance of financial or other covenants that may be contained in the convertible preferred stock provisions or underlying investment agreement, or a material failure to meet the business plan).

(d) *Conversion Rights*

Typically, shares of convertible preferred stock may be converted into shares of common stock at the election of the holder at any time prior to redemption and are automatically converted into common stock upon the occurrence of certain specified events. The most common triggering event for automatic conversion is the completion of a firm commitment underwritten public offering of the company's common stock at a specified price per share and with proceeds to the company of at least a specified amount. Occasionally, automatic conversion is triggered by the attainment of specified financial goals. In many deals, shares of convertible preferred stock may also be converted into shares of common stock upon the vote of a specified percentage in interest of the holders of the convertible preferred stock.

The conversion ratio usually is expressed by a formula based on the original purchase price paid for the preferred stock, which initially yields a one-for-one conversion ratio. The conversion ratio is subject to adjustment to take into account

- stock splits, stock dividends, mergers, consolidations, reclassifications, recapitalizations, and similar extraordinary corporate transactions; and
- sales of common stock or securities exchangeable for or convertible into common stock at prices lower than those paid by the venture capital investors (so-called dilutive issuances).

Typically, no adjustment is made for accrued and unpaid dividends in the conversion ratio, and such dividends are usually forfeited on conversion. Increases in the conversion ratio (other than pursuant to valid antidilution adjustments) may trigger constructive dividends to the investors under I.R.C. § 305. Treasury Regulations issued pursuant to I.R.C. § 305 provide examples of antidilution adjustments that will not trigger a constructive dividend.

Antidilution adjustments can have a dramatic effect on the number of shares of common stock issuable upon conversion of the preferred stock. These adjustments usually are made on either a "ratchet" or "weighted-average" basis. Ratchet antidilution provisions apply the lowest sale price for any shares of common stock (or common equivalents) sold by the company after the issuance of the preferred stock in determining the conversion ratio. Thus, an investor's preferred stock becomes convertible into that number of shares of common stock equal to such investor's investment divided by the lower sale price, instead of such investor's actual purchase price. Ratchet antidilution provisions do not take into account how many shares of stock were issued at the lower price, and therefore can be extremely harsh on the common stockholders (who are typically the entrepreneurs and management) as the dilutive effect of the issuance of the new shares falls almost exclusively on the common stockholders. Often this disincentivizing effect on the common stockholders must be counteracted by additional issuances of stock options or other incentive grants to the affected holders in order to retain valued personnel. Because these provisions can operate unfairly in extreme situations and can cause significant problems with (or even effectively prevent) refinancing of a troubled company, many practitioners believe that a ratchet is appropriate only to accomplish a retroactive price adjustment when there has been substantial disagreement as to price and another financing is expected to occur within approximately one year. In such circumstances, the charter may provide for a ratchet antidilution for a specified period of time and weighted-average antidilution protection thereafter.

Weighted-average (or "formula") antidilution provisions are less harsh on the common stockholders and consequently less favorable to the preferred stockholders. These provisions adjust the conversion ratio by application of a weighted average formula based on both sale price and number of shares of common stock (or common equivalents) sold. Essentially, these provisions treat all shares of common stock and common equivalents outstanding prior to the new issuance as having been issued at the conversion price in effect prior to the issuance, and then lower the conversion price as a result of the new issuance to the weighted average of the purchase prices of the outstanding and newly issued shares.

In either case, antidilution provisions generally provide an exception for a predetermined pool of shares that may be issued as incentives to employees, consultants, and officers, or shares issued to strategic partners such as lenders, or shares issued in connection with an acquisition by the company, without triggering an adjustment of the conversion ratio. The size of that pool of shares is negotiated, and increasing the size of the pool typically requires the consent of the venture capital investor. Both the preferred and common stockholders are diluted when such shares are issued.

Where the venture capital investor group is concerned that future capital be available to the company from the group, the terms of the preferred stock may require an investor to participate in future rounds of financing. Failure to participate may cause the investor to lose certain rights or, in some circumstances, cause the investor to forgo certain extra benefits provided to investors who participate. These provisions are typically referred to as "pay-to-play" provisions. The harsher forms of pay-to-play provisions—i.e., the "stick"—will trigger a conversion of the nonparticipant's preferred stock into common stock and the loss of many contractual rights, such as the right to designate board members, preemptive rights, and rights of first refusal and cosale. Milder forms of pay-to-play provisions will merely trigger a loss of antidilution protection. This latter type of pay-to-play provision raises structural complications regarding establishment of different classes and series as investors fail to participate in subsequent financing rounds. Some of the benefits of participating—i.e., the "carrot"—could include a discounted purchase price or increased or improved participation or governance rights.

(e) *Redemption*

Redemption offers the investor a means of recovering their initial investment. Typically, but not always, when redemption is not automatic it can be triggered by one or a group of investors and not the company. Redemption is also an area where geographic differences become clear, with East Coast deals typically including redemption features and West Coast deals typically leaving these features out.

While investors including these features desire to have a stepped-up redemption price or a redemption premium, I.R.C. § 305 effectively limits the step-up or premium in the redemption price. Treasury Regulations under I.R.C. § 305 provide that, if a corporation issues preferred stock that may be redeemed by the issuer (or, in certain cases, a third party) at a price higher than the issue price, the difference (the redemption premium) will be treated as a constructive distribution on the preferred stock paid over the period of time from the date of issuance until the expected redemption. The holder must pay tax on these constructive distributions to the extent that the company has current or accumulated earnings and profits, even if no cash payments are made to the holders by the company prior to redemption. Also, I.R.C. § 305 provides that certain accrued dividends paid at redemption must be accounted for in the same manner as "original issue discount." This treatment also depends on the company having current or accumulated earnings and profits. These tax rules are often avoided by adding participation features to the preferred stock. In such cases, the rules treating redemption premiums as constructive dividends do not apply. Preferred stock with these characteristics is sometimes referred to as "tax common stock."

Redemption may be optional or mandatory. Venture capital investors favor preferred stock that is redeemable only at the option of the holder or, less often, a group of holders. Less favorable to them, but acceptable, is a mandatory redemption after, typically, five to seven years. Still less attractive to them, but occasionally accepted in conjunction with a fixed redemption date or right to redeem at their option, is preferred stock that is redeemable at the option of the company after a number of years. Since redemption premiums may be limited as a result of certain tax rules, a redemption of the preferred stock in either situation may force the investor to choose between being redeemed at a price that yields a disappointing return and converting to common stock (and thus giving up the protections of the preferred stock) at a time when the company may not yet be a "success" from the investors' perspective. Further, "callable" preferred stock creates an incentive for the company to redeem the stock as soon as the value of the underlying common stock exceeds the redemption price. It is for this reason that this feature is not typically seen in venture capital transactions.

For company cash flow purposes, the preferred stock is often redeemable in installments over a period of years, commencing five to seven years after the investment. Also, the preferred stock may require the company to establish a sinking fund to provide assurance of timely redemption. Redeemable preferred stock is reflected on a company's balance sheet above the stockholders' equity line.

§ 11.6.2 Principal Terms of Debt Securities

Debt securities enable the venture capital fund to receive a current return on its investment through receipt of interest payments. Although the terms of debt securities may be structured to resemble preferred stock in many aspects, significant differences between the two securities exist.

First, debt securities do not carry the right to vote for the election of directors or on other stockholder matters. Accordingly, the investor's ability to directly influence management of the company is diminished, and the investor must resort to voting agreements and proxies to participate in the election of directors or, alternatively, rely on indirect means of influence such as the affirmative and negative covenants contained in the investment agreement. Further, the investor's status as a creditor of the company in any bankruptcy proceedings may be affected by principles of "equitable subordination" to the extent that equity-like control is actually exercised, with the result that the investor's debt security may be subordinated in right of payment to the claims of other third-party creditors of the company who do not exercise control.

Second, the investor's right to receive interest under a debt instrument is more secure than the right to receive dividends on preferred stock, inasmuch as payment of dividends may be restricted by state corporate laws relating to legally available funds and by the requirement that dividends must be declared by the board of directors.

Finally, although a debt security may rank prior to preferred stock in terms of a claim on corporate assets in liquidation, this advantage is at the cost of creating a weaker balance sheet, which may have adverse effects in terms of trade and commercial bank credit, even where subordination provisions are present.

The following principal issues are generally addressed in structuring debt securities.

(a) *Interest Rate*

Generally, interest is at a fixed rate. The interest rate is directly related to the priority of the debt—the more subordinated the debt, the higher the risk and, consequently, the higher the interest rate. Further, if the debt has an equity feature, such as conversion rights or detachable warrants, the interest rate typically is lower than for a similar security without an equity feature. In setting the interest rate, care must be taken to ensure compliance with applicable state usury laws, which may impose both civil and criminal penalties.

If the investor already holds an equity interest in the company, the debt must bear interest at a rate equal to or greater than the rate specified by the IRS pursuant to I.R.C. § 7872. If the interest rate is less than that rate, the holder of the debt may be deemed to have received interest at the specified rate for tax purposes and be taxed on such "imputed interest," even though the holder receives no additional cash payments.

Interest payments may be deferred for a period of time because of cash flow considerations for the company. Interest deferral, however, may result in an "original issue discount" under I.R.C. § 1273, causing the investor to realize taxable interest income on an economic accrual basis, even though the actual interest payment is deferred.

(b) *Repayment*

Repayment of principal is often scheduled in quarterly, semiannual, or annual installments, commencing four to six years into the term, or in a single "balloon" payment at maturity.

(c) *Optional Prepayment*

The company may elect to prepay the debt, often at a premium. Since prepayment has the effect of extinguishing any conversion rights, the right to prepay generally is deferred to such time as initial principal installments fall due.

(d) *Equity Features*

Because no pure debt investment has the upside return potential of an equity investment, venture capital investors generally seek an opportunity to acquire equity to improve their return on a debt investment. These equity features may be in the form of conversion rights, detachable warrants, or a parallel direct stock purchase, each of which has its advantages and disadvantages and tax and securities law implications.

For example, convertible debt securities avoid the "original issue discount" income problems often involved in the debt with warrants alternative and enable the holder to tack the holding periods of the debt securities with that of the stock into which they are converted for capital gains purposes and for purposes of Rule 144 under the Securities Act of 1933, as amended (hereinafter Rule 144). As convertible debt securities are repaid, however, the equity feature disappears.

The parallel direct common stock purchase alternative avoids the tax and securities issues of the others but puts a larger portion of the investor's investment at risk. The common stock typically is purchased at a relatively low purchase price, thereby minimizing the amount at risk as equity and providing support for a relatively low valuation of the common stock for purposes of future grants of stock options and elections under I.R.C. § 83(b). Disadvantages of this alternative also include the lack of antidilution protection, liquidation preferences, and redemption premiums found in preferred stock investments. While these disadvantages may be alleviated by agreements between the investors and the company, such agreements may result in a higher purchase price for the stock.

A debt security coupled with a detachable warrant can avoid the upfront equity investment of the parallel direct stock purchase and the decreasing equity potential of a convertible debt security. The warrants usually can be separately transferred and survive repayment of the related debt securities. If the warrants are purchased together with debt securities as an investment unit with a price equal to the face amount of the debt securities, that portion of the purchase price of the unit equal to the fair market value of the warrants must be allocated as the purchase price of the warrants for tax purposes. If the value allocated to the warrants exceeds a de minimis amount as determined in accordance with regulations under I.R.C. § 1273, the investor must recognize "original issue discount" income on the debt securities.

(e) *Subordination*

Debt issued to venture capital investors generally is subordinated to bank and other institutional borrowings and thus may be viewed as equity by lenders. Complex subordination provisions are often required to regulate the relationships between senior lenders and subordinated debtholders in the event of defaults or insolvency.

(f) *Affirmative and Negative Covenants*

Debt instruments may be tied into extensive affirmative and negative undertakings by the company, which would usually be contained in the investment agreement. In addition to standard covenants used in a venture capital financing, these may include lengthy financial covenants of the variety typical in a commercial lending transaction. In situations where loans are made to existing portfolio companies by venture investors with substantial existing rights and ownership of the issuer, the covenant requirements tend to be less rigorous.

(g) *Defaults*

In the event certain specified defaults occur, the debt security typically must be repaid by the company. Defaults may include

- material breaches of representations and warranties,
- breach of covenants that are not remedied within a cure period,
- nonpayment of principal and interest on debt instruments,
- acceleration (cross-default) of senior debt, and
- insolvency and bankruptcy.

(h) *Security*

Generally a debt instrument is issued to a venture capital investor on an unsecured basis, although collateral is sometimes given in asset-based transactions such as leveraged buyouts. Another common exception to the general rule is in small business investment company (SBIC) financing, in which adequate collateral and personal guaranties are often required.

§ 11.7 THE INVESTMENT AGREEMENT

The principal legal document in a venture capital financing is a long-form investment agreement. The agreement has four principal business objectives:

- most importantly, to set forth the detailed substantive terms of the investment contained in the term sheet, as well as less substantive items;
- to serve as the basic disclosure document in which the relevant historical, business, financial, and legal data relating to the enterprise is set forth or referenced;
- to present, through the use of conditions precedent to closing, a “stop-action” photograph or image of the issuer that must exist at the time of closing—the level of detail of this photograph varies depending on the number of previous financings and the complexity of the company’s operations; and
- to define the several business parameters within which the enterprise must operate in the future, including both affirmative and negative covenants.

Unlike the term sheet, the investment agreement is intended to be a binding contract. The most common consequence of a breach of the investment agreement is the refusal by the investor to close the transaction because of the company’s failure to satisfy a condition precedent or the existence of a significant misrepresentation by the company. Once the closing has occurred, remedies in the nature of rescission are rare. Moreover, while claims for damages do arise, they are uncommon in the high-risk venture capital area. Common remedies available for breach of a covenant are specific performance and injunctive relief. As a practical matter, however, remedies that are self-executing, such as antidilution protections or extraordinary voting rights granted to preferred stockholders, are more formidable than remedies that frequently arise in commercial contract disputes or amount to waving a stick in the air, such as accelerated repayment of debt securities.

§ 11.7.1 Description of the Transaction

The investment agreement memorializes the terms of the transaction. Consequently, the agreement should identify the securities subject to the agreement, the number or amount of securities being purchased by each investor, and the purchase price.

If the investment involves a debt security or a stock purchase warrant, the form of the security or warrant should be an exhibit to the investment agreement. If the investment involves a class of stock other than conventional common stock, the corporate charter provisions setting forth the terms of the class of stock should be an exhibit to the investment agreement.

If more than one investor participates in the financing, they may be listed or referenced in an exhibit to the agreement. The agreement also makes clear that the investors’ obligations are several, not joint. In some cases, investors require separate but identical investment agreements with each of the other investors. In that situation, the conditions to each investor’s obligation to purchase the securities usually are that

- identical investment agreements have been executed simultaneously by the company and each other investor,
- such agreements have not been amended and are in full force on the closing date, and
- a specified minimum amount has been raised by the company.

In some transactions, the entire investment proceeds are not made available to the company at a single closing. If the purchase is made in two or more installments over fixed periods of time, the major condition precedent to closing each successive installment is the absence of any material adverse changes affecting the company since the initial closing. In a “staged” or “milestone” investment, the purchase of additional securities at subsequent closings is also conditioned on the accomplishment of certain financial or operational goals, such as the attainment of specified revenue levels or completion of the development of a new product, as well as the absence of adverse changes. A staged or milestone investment serves as an incentive to management to proceed diligently with the development of its business and enables the investor to target the investment with a maximum impact on the development of the business.

§ 11.7.2 Representations and Warranties of the Company and the Founders

The representations and warranties of the company comprise an integral part of the investment agreement. In some circumstances (typically in early-stage investments in companies with no or little prior operating history), the founders of the company may also be asked to make certain representations and warranties about the founders and also to confirm some or all the representations and warranties being given by the company. Since the venture capital investor has often conducted a factual review of the company’s business and the founders prior to issuing the term sheet, the company’s and any founders’ representations and warranties are not intended primarily to “screen” the company for suitability as an investment, but rather to provide full disclosure of the fine details of the company's operations that may be relevant in advising management on the future conduct of the business. By focusing on the representations and warranties in the investment agreement, issues or problems not previously addressed may be discovered and resolved. The disclosure of significant adverse information not previously known to the investor, however, may cause the valuation or other material terms of the investment to be renegotiated or, in severe cases, may scuttle the investment.

The following representations and warranties are customary in venture capital investment agreements.

- **Organization and authority.** The company is properly organized, in good standing, and has legal authority to conduct its business.
- **Capitalization.** The company describes its authorized capitalization and the status of outstanding securities, including warrants, options, and convertible securities. Any transfer restrictions, repurchase rights, or preemptive rights are also described. Often this representation states that all the outstanding stock was issued in compliance with applicable federal and state securities laws, which provides the investor with comfort that no potential rescission rights exist.
- **Validity of securities.** The securities being purchased are duly authorized, validly issued, and fully paid and nonassessable in the case of capital stock, or valid, binding, and enforceable in the case of debt securities.
- **Corporate action.** All necessary actions under state corporate law, and the company's corporate charter and bylaws, have been taken to authorize the transaction and to issue the securities.
- **Compliance with other agreements.** No violations of the company's corporate charter, bylaws, or other valid agreements exist, or will exist as a result of the transactions contemplated by the investment agreement.
- **Compliance with laws.** The company has operated its business in compliance with all applicable laws and regulations and has obtained and is in compliance with all necessary permits, licenses, and authorizations applicable to its business.
- **Financial information.** Audited and internal unaudited financial statements have been prepared in accordance with generally accepted accounting principles and fairly present the financial position and operating results of the company. Statements as to specific categories of items, such as inventory valuation and status of accounts receivable, and the absence of any undisclosed liabilities may be included. No adverse changes have occurred since the date of the most recent financial statements furnished. This representation provides the investor with comfort on the financial statements on which the investment decision was made.
- **Ownership of properties and assets.** The company possesses sufficient ownership rights in its business assets (particularly its patent, copyright, trademark, and other intellectual property rights) to conduct its business. In situations where the founders have been asked to make representations and warranties, the founders are typically asked to confirm that they have not provided the company with any intellectual property rights or other assets of a prior company or employer.
- Intellectual property. The company owns or can acquire on commercially reasonable terms all intellectual property rights necessary to conduct its business; is not infringing intellectual property rights of others; to its knowledge no other party is infringing any of its intellectual property rights; and the company has not embedded any open-source code in any of its products. In situations where the founders have been asked to make representations and warranties, the founders are typically asked to confirm this point as well.
- **Insurance.** The company has insurance in such amounts and covering such risks as is carried by companies of equivalent size engaged in similar businesses.
- **Governmental approvals.** All consents and approvals of governmental agencies necessary to complete the transactions contemplated by the investment agreement have been obtained. This representation covers compliance with federal and state securities laws, including the possibility that the transaction may be integrated with other securities sales.
- **Taxes.** The company has paid all federal, state, and local taxes due and has filed all required tax returns.
- **Material agreements and relationships.** Disclosure is made of material agreements, written or oral, entered into by the company; loans by the company to any person; assumptions or guarantees by the company of indebtedness incurred by any person; and material adverse changes in the company's relationships with its suppliers or customers. In situations where the founders have been asked to make representations and warranties, the founders are typically asked to confirm that they are not parties to any agreements that would limit or prohibit them from providing expected services to the company or would restrict the company's future activities.

- **Environmental protection.** The company and its property are in compliance with all federal, state, and local environmental and health laws, including compliance with all permits, licenses, and approval requirements and compliance with any laws, orders, or directives concerning cleanup of hazardous substances. Potential environmental liability under various statutes has been disclosed.

- **Absence of litigation.** No litigation or other proceedings exist, or are threatened, that would adversely affect the company's business or the transactions contemplated by the investment agreement. The absence of pending or threatened litigation is important to the venture capital investor to ensure that the investment proceeds are not diverted from financing implementation of the business plan to cover litigation costs. In situations where the founders have been asked to make representations and warranties, the founders are typically asked to confirm that they are not parties to any litigation or controversy that would limit or prohibit them from providing expected services to the company, or that would restrict the company's future activities.

- **Employee matters.** This representation is intended to elicit disclosure of employment agreements and any restrictions relating to employment of key personnel or use of business information, particularly as a result of prior employment of such personnel. This representation can be particularly important in uncovering the potential for any claims to the company's technology or products because of prior employment of the entrepreneurs or key employees. This representation may also include statements that the company has appropriate nondisclosure and inventions agreements with its employees and consultants. Founders are often asked to make this representation personally.

- **Transactions with insiders.** Disclosure is made of any direct or indirect transactions between the company and its directors, officers, or stockholders.

- **Registration rights.** The venture capital investment agreement ensures that the investors have the right to cause the company to file a registration statement under the federal securities laws and the right to participate in any such registration. Disclosure is made of any conflicting agreements with prior investors.

- **United States real property holding corporation.** The company certifies that it is not now and has never been a "United States real property holding corporation," as defined in I.R.C. § 897, and that the company has filed with the IRS all statements, if any, with its federal income tax returns that are required under related regulations.

- **Small business concern.** If a member of the investment group is an SBIC, the company, including its "affiliates," is a "small business concern" and the information pertaining to the company set forth in any required Small Business Administration forms is accurate and complete.

- **Brokerage.** Disclosure must be made of any finder's or broker's fees or commissions payable in connection with the transaction.

- **Disclosure.** The business plan used to seek financing and other information supplied to investors (including the representations and warranties of the company contained in the investment agreement), taken as a whole, do not contain any untrue statement of material fact or omit to state a material fact necessary to prevent the statements made in that information from being misleading.

In contrast to the company, venture capital investors typically make few, if any, representations and warranties in the investment agreement. The primary purpose of the investors' representations and warranties is to provide the company with information needed for it to establish compliance with applicable federal and state securities laws.

§ 11.7.3 Covenants and Undertakings of the Company

The investment agreement usually contains several affirmative and negative undertakings of the company relating to the future conduct of its affairs. Affirmative covenants are actions, positions, or results that the company promises to achieve or undertake. Negative covenants are actions, positions, or results that the company promises to avoid.

If, under the terms of the investment agreement, the board of directors is to be controlled by inside management, or if the investment is primarily in a debt security, the covenants are frequently extensive. In an equity-oriented investment where the venture capital investor controls the board of directors, the venture capital investor generally relies on this control to influence management and does not, as a rule, impose extensive contractual restrictions on the conduct of the business by insisting on extensive affirmative and negative covenants. In such a situation, the affirmative covenants might merely provide that the investor receives periodic financial information and is represented on the board. The negative covenants might limit only the company's ability to amend its corporate charter or merge or sell its assets without the venture capital investor's consent.

Often venture capital investors that are not the "lead" investors require the right to advise and consult with management—if not a seat on the board of directors—and the right to receive periodic financial reports. These rights may be of significance to the venture capital investors that are trying to obtain "management rights" necessary to qualify as a "venture capital operating company" under Department of Labor regulations. For venture capital funds that have ERISA investors, such as private pension funds, establishing venture capital operating company status may be essential.

Both affirmative and negative covenants may remain in effect as long as the venture capital funds hold any of the investment securities. Alternatively, the covenants may terminate upon the occurrence of certain events, such as the completion of a qualified public offering, conversion of debt-oriented convertible securities into equity, or mere passage of time.

(a) *Affirmative Covenants*

Some of the customary affirmative covenants are as follows:

- **Payment of taxes and claims.** The company will pay all lawful taxes, assessments, and levies upon it or its income or property before they become in default. This covenant sometimes provides that all trade debt and principal and interest on debt securities acquired by the venture capital investors are to be paid when due.
- **Property and liability insurance.** The company will maintain insurance against hazards and risks and liability to persons and property to the extent customary for companies engaged in the same or similar businesses.
- **Maintenance of corporate existence.** The company will maintain its corporate existence and all rights, licenses, patents, copyrights, trademarks, and intellectual property rights useful in its business and will engage only in the type of business described in the business plan.
- **Legal compliance.** The company will comply with all applicable laws and regulations in the conduct of its business.
- **Access to premises.** Venture capital investors or their representatives generally will be permitted to inspect the company's facilities, books, and records.
- **Accounts and reports.** The company may be required to maintain a standard system of accounting in accordance with generally accepted accounting principles consistently applied and keep full and complete financial records. Venture capital investors generally require that year-end financial statements be audited by a firm of independent public accountants with nationally recognized standing.
- **Repair and maintenance.** The company will keep all necessary equipment and property in good repair and condition as required to permit the business to be properly conducted.
- **Approval of budgets.** Venture capital funds will frequently require management to produce comprehensive annual operating and capital budgets for approval by the investors or by the board of directors. Revisions of such budgets during the year may also require advance approval.
- **Protection of proprietary rights.** The company will agree to take all necessary steps to protect proprietary developments made in the future, including causing all key employees to sign confidentiality and proprietary rights agreements.
- **Compliance with key agreements.** The company will enforce its rights under key agreements, such as the stockholder agreement, and will cause future stockholders to join the agreement.
- **Life insurance.** Venture capitalists often require the company to maintain insurance on the lives of key officers and employees. The face amount in some cases may be as much as the purchase price of the securities, and the insurance proceeds are generally payable to the company but may be payable directly to the venture capital investors, particularly if they hold debt securities.
- **Rule 144A information.** The company is required (as long as it is privately held) to provide to potential third-party purchasers of the shares held by the investors, upon request, the information required to permit the investors to sell their shares to such third parties pursuant to the exemption from registration under the Securities Act provided by Rule 144A for sales to institutional buyers.
- **Environmental matters.** The company will materially comply with any and all environmental laws that apply to it, its properties, and all activities thereon, including governmental directives to clean up hazardous contamination. The company will keep the investors informed regarding its discharge and handling of hazardous materials and any communications from any governmental entity relating to such discharge and handling.

- **Board of directors.** Venture capital investors generally seek assurances that they will be represented on the company's board of directors and any committees of the board. The right to be represented on the board and its committees may be supported by voting agreements with the principal stockholders. If a venture capital investor is not to be represented on the board of directors, the company may be required to notify the investor of the time and place of board meetings and to permit the investor or its representatives to attend such meetings and receive written material disseminated to directors. Frequency of board meetings, the ability of the investor to call a board meeting, and financial arrangements may also be covered.

- **Financial and operating statements.** The company will invariably be required to provide the venture capitalists with detailed financial and operating information. The information to be provided may include

  – annual, quarterly, and sometimes monthly reports of sales, production, shipments, profits, cash balances, receivables, payables, and backlog;

  – all statements filed with the Securities and Exchange Commission (SEC) or other agencies;

  – notification of significant lawsuits or other legal proceedings; and

  – any other information that the investor may need for its own voluntary or involuntary filing requirements. Particularly where the investors are acquiring debt securities or preferred stock containing extensive financial and other covenants, financial statements are required to be accompanied by a certificate from the company's chief executive or financial officer and, in the case of audited financial statements, from its auditors, to the effect that the company is in compliance with all provisions of the investment agreement. The right to receive financial information is often terminated when the company has a class of securities registered under the Securities Exchange Act of 1934 to avoid dissemination of "inside" information. Although companies generally concede the legitimate interests of investors to receive business information, negotiation over the scope and form of this information may be considerable in view of the operational burden and potential liabilities it can impose on management.

- **Current ratio, working capital, or net worth.** These covenants normally are included only in debt financings and are agreements to maintain the current ratio, working capital, or net worth, either at a minimum amount or as specified for various time periods. They may be keyed to projections made by the company. Accordingly, care should be taken by the company in preparing the business plan to project financial results and conditions that management is comfortable in undertaking to attain on a contractual basis.

- **Use of proceeds.** Often the company agrees to apply the proceeds deriving from the financing to a specified use. The investors sometimes require that the proceeds be applied within a narrow area of the business in connection with a specific financing plan or may simply require that the funds be used for working capital.

(b) *Negative Covenants*

In contrast to affirmative covenants, which generally exhort the company to undertake actions that it might not ordinarily choose to take in the normal course, negative covenants contained in the investment agreement are intended to prevent the company from taking actions it otherwise might be inclined to take, unless the investors have consented in advance. Typically, negative covenants relate to matters that would affect the fundamental nature of the business in which the investment has been made (e.g., mergers and acquisitions) or would alter the balance of control between the venture capital investors and entrepreneurs reached in the investment agreement (e.g., controls on stock issuances). Since negative covenants limit the scope of managerial flexibility, they are often the subject of sharp negotiation. This is all the more so because the investors' remedy upon material breach of a negative covenant often is quite dramatic—such as immediate acceleration of indebtedness in the case of debt securities. As suggested above, there is a trade-off between the degree of investor control of the voting power of the company's equity securities and board of directors and the strictness of the negative covenants imposed on the company. Many typical negative covenants are described below.

- **Mergers, consolidations, and sale or purchase of assets.** Mergers, consolidations, acquisitions, and the like, with respect to the company or any of its subsidiaries, are generally prohibited without the investors' advance approval. Liquidation and dissolution of the company or any subsidiary and the sale, lease, pledge, or other disposition of substantial assets without consent also may be barred. Restrictions may be placed on the company's purchase of capital assets.

- **Dealings with related parties.** Transactions between the company and its officers, directors, or stockholders may be prohibited unless effected on an arm's-length basis and on terms no less favorable to the company than could be obtained from unrelated persons. Approval of all transactions with affiliates by either the board or the investors may be required.

- **Change in business.** The company will not change the nature of its business as described in its business plan.
- **Charter amendments.** The investors may prohibit the company from amending its corporate charter or bylaws without their consent. More narrowly drawn covenants might prohibit only certain specified actions, such as a change in the capital structure, without the investors' consent.
- **Distributions and redemptions.** The company typically agrees not to make any cash dividend distributions to stockholders other than required dividends to holders of preferred stock. Dividends may be prohibited until a given date or until the completion of a qualified public offering of the company's stock or may be limited to a fixed percentage of profits above a set amount. In addition, the company may covenant not to repurchase or redeem any of its securities, except in accordance with the terms of the securities purchased by the investor (e.g., redeemable preferred stock), employee plans (e.g., forfeiture of stock upon termination of employment), or agreements with stockholders (e.g., right of first refusal).
- **Issuance of stock or convertible securities.** The investors may prohibit the company from issuing any securities that would result in dilution of an investor's position. This restriction includes the issuance of securities of the type purchased by the investor and of any securities convertible into such securities at a price less than that paid by the investors. Alternatively, a formula may be employed so such an issuance automatically triggers an improved conversion rate for the securities purchased by the investor. Frequently, these covenants are included in the terms of the securities themselves.
- **Liens and encumbrances.** The investment agreement (generally for debt-oriented securities, including redeemable preferred stock) may provide for restrictions on liens, pledges, and other encumbrances, with exceptions for such liabilities as real estate mortgages. Separate restrictions can be placed on leases of real property or equipment.
- **Indebtedness.** The company may agree to restrictions on future indebtedness. Unsecured bank debt is frequently permitted. Certain dollar limits on other debt are common.
- **Investments.** Restrictions against investing in other companies may be imposed by the investor. Exceptions are made for investments in wholly owned subsidiaries.
- **Employee compensation.** The company may agree to limit employment and other personal service contracts of management or key personnel to a maximum term and a maximum amount of annual compensation. In addition, the investment agreement may prohibit the acceleration or termination of vesting schedules applicable to stock held by officers, directors, and employees.
- **Financial covenants.** Negative financial covenants are frequently imposed on a company in a debt-oriented investment, such as prohibiting key ratios or financial conditions from exceeding certain limits or limiting the company from incurring losses in excess of a certain amount. Semantics often determine whether a financial covenant is affirmative or negative in nature. Clear definition of financial and accounting terms is critical. Short of resulting in a default on securities, failure to comply with financial covenants may trigger adjustments in conversion ratios of securities or give rise to preferential voting or other rights for the investor.

(c) *Other Covenants*

In addition to the numerous affirmative and negative covenants described above, the venture capital investment agreement customarily contains a number of more complex undertakings by the company, which are generally set forth in the agreement. Two of the more typical of these covenants pertain to registration rights and rights to participate in future financings. Another such provision, indemnification of the investors for breach of the investment agreement, is also discussed briefly below.

Registration Rights

Venture capital investors have traditionally seen the right to register securities for public sale under the Securities Act of 1933 and state securities laws as representing the most advantageous vehicle for achieving liquidity and realizing a return on investment. The potential of an enterprise to achieve a size conducive to a public offering is an imperative of most venture capital investments; accordingly, the right of the investor to participate in the public market for the company's securities is an area in which the venture capitalist concedes few limitations on its flexibility of action. Registration rights are intricately bound up in the complexities of federal and state securities regulation and must be thoroughly understood by the company and its counsel. Registration rights provisions in a venture capital investment agreement are highly stylized and usually include the following key elements.

Securities Available for Registration

Registrable securities are invariably limited to common stock, including shares issuable on conversion of other securities. After-acquired common stock held by the investor may also be included. If the investor is participating in a second- or third-round financing, it must consider to what extent its registration rights are coordinated or "pooled" with registration rights granted to investors in previous financings.

"Piggyback" Registration Rights

Investors will have the right to include shares in any registration that the company undertakes either for its own benefit or for the account of other holders of securities. Exceptions are generally made for registrations involving employee stock plans or acquisitions. Piggyback registrations frequently are unlimited in number on the theory that no significant burden is imposed on the company by requiring it to include additional shares in a registration that it is otherwise undertaking. Except for the company's initial public offering, investors may be guaranteed a minimum participation in piggyback registrations.

Demand Registration Rights

Investors frequently obtain the right to require an issuer to register their shares on demand and without regard to the registration of shares for the account of any other person. Demand rights assure the investor access to the public market. Theoretically, unrestricted demand registration rights enable an investor to force a company to go public; as a practical matter, demand rights are rarely, if ever, used to this end, although their presence may influence the decision of a company to go public. Because of the expense involved, demand rights may be limited in number, unless registration is available on a short-form registration statement such as Form S-3. In addition, investors may agree to limit the exercise of demand rights to the holders of a minimum specified percentage of registrable securities to avoid unduly small registrations.

Marketing Rights

Piggyback registration rights generally contain provisions enabling the underwriters managing the public offering to cut back, on a pro rata basis, the number of shares to be registered by selling to securities holders if, in the underwriters' opinion, such a cutback is necessary or desirable to market the public offering effectively. If securities holders other than the venture capital investors also hold registration rights, the relative marketing priorities of the various groups, including management, must be addressed.

Indemnification

Each party agrees to indemnify the other against liabilities for which it is responsible arising out of a registration. Although the extensive indemnification provisions of an underwriting agreement frequently supersede the terms of the investment agreement, they are nevertheless important because underwriters typically look to the company and any major selling stockholders for indemnification on a joint and several basis and leave to those parties the allocation of any liabilities among themselves.

Procedural Covenants

Many registration rights provisions contain undertakings to comply with certain procedural matters involved in a registration, such as participation in the preparation of a registration statement, qualification under state securities laws, and entitlement to legal opinions and accountants' comfort letters.

Availability of Rule 144

The company agrees that once it has gone public, it will file all reports and take all other action necessary to enable the investors to sell shares that have not been included in a company registration statement in the public market under the exemption from registration contained in Rule 144 under the Securities Act of 1933.

Expenses of Registration

Because of the cost involved in a registration of securities, investors typically require the company to agree at the time of the initial investment to bear the expenses of registration, exclusive of underwriters' discounts or commissions applicable to the investors' included shares.

Rights to Future Financings

Venture capital investors often insist on a right to participate in future financings by the company. On the upside, this offers the investors an opportunity to maintain or increase their interest in the success of the enterprise; on the downside, the investors receive some protection against dilution or loss of their initial investment in the event financing must be sought under distress situations. The right to participate may include

- rights of first refusal to assume the entire financing (each investor on a pro rata basis with other members of the investor group);
- rights to purchase sufficient shares to maintain the investor's preissuance percentage ownership; these rights are also called preemptive rights, particularly if set forth in the charter; and
- rights of prior negotiation to discuss and negotiate financing opportunities with the company prior to the company making offers to others.

First refusal and preemptive rights typically contain oversubscription rights to permit investors to buy any portion of the securities not subscribed for by other investors or security holders.

Typically, first refusal and preemptive rights terminate immediately prior to a qualified public offering. In certain cases, however, venture capital investors require the right to purchase shares in the company's initial public offering (IPO) in an amount that is at least sufficient to maintain their percentage ownership in the company. If exercise of these IPO participation rights is limited by applicable law, venture capital investors may negotiate for the right to purchase privately issued securities of the company contemporaneously with the company's IPO on terms designed to approximate the economic benefit the investors would have received had they been legally permitted to exercise IPO participation rights.

Indemnification for Breach of Agreement

Particularly in the case of startup companies, venture capital investors may occasionally require founders, top management, or both to share personal responsibility for the representations and warranties made by the company in the investment agreement and to indemnify the investors for any breaches thereof. From the investors' point of view, imposing the specter of personal liability on the insiders can be an effective means of ensuring complete and accurate disclosure of all material business information. Indemnification by insiders also circumvents the anomaly of investors seeking indemnification from the company out of the capital that they have invested in the business. On the other hand, personal liability for disclosure matters that may be outside the entrepreneur's reasonable knowledge may be an unfair burden to place on the entrepreneur. For this reason, in cases where personal responsibility for representations and warranties is required, care should be taken to focus that responsibility in areas of special knowledge of the entrepreneur (e.g., ownership of proprietary rights and compliance with prior employment arrangements) and to distinguish between the risks assumed by the company and those assumed by the individual (e.g., unqualified representations versus "best knowledge" representations). Termination of indemnification obligations often occurs after a stated period of time, usually not exceeding two years, or after the issuance of audited financial statements covering a one- or two-year period.

§ 11.7.4 Conditions to Closing

Conditions precedent to closing are used for two principal purposes. The most obvious is to guarantee that certain fundamentals relating to the securities and the particular transaction are in place, with receipt of favorable legal opinions being a classic example. In addition, conditions are used as negotiating tools to change or affect the affairs of the company. For example, a common closing condition may involve the contemporaneous execution of a bank loan agreement satisfactory to the investor or the consummation of a significant commercial transaction with a customer.

Many venture financings contemplate a simultaneous signing of the investment agreement and closing. Consequently, there is no technical need for a set of conditions designed to cover the time period between execution of the agreement and a subsequent closing. Notwithstanding a simultaneous signing and closing, the use of express conditions serves to expedite the negotiations and to assist the closing process by serving as a checklist of actions to be taken in connection with the implementation of the transaction.

Common closing conditions include

- opinion of counsel for the company;
- execution of the several ancillary agreements, including employment letters, noncompete and/or nonsolicitation agreements, employee confidentiality and proprietary rights agreements, and stock restriction agreements;
- elections and resignations of directors; and
- compliance certificates by senior management.

§ 11.8 ANCILLARY AGREEMENTS AND DOCUMENTS

§ 11.8.1 Stockholder Agreement

The stockholder agreement is designed to control the transfer and voting of the equity securities of the company by key stockholders so stable ownership and management of the enterprise may be maintained for the term of the investment. This control is accomplished through restrictions on the sale of stock by insiders, which have the effect of limiting the stockholder group to persons who are known to the investors, and through voting agreements, which ensure that the balanced composition of the board of directors will be perpetuated. The principal provisions contained in a typical stockholder agreement to achieve these results are described below.

(a) *Right of First Refusal*

Key management stockholders may grant the company, the venture capital investors, or both the right to purchase their shares on the same terms as those contained in a bona fide offer from a third party. Investors participate in the right of first refusal on a pro rata basis and have oversubscription rights to acquire any offered shares that are not purchased by another investor. Rights of first refusal generally are *not* extended to the company or insiders by the venture capital investors, since the existence of such terms would tend to chill any sale of an entire block of shares by the investors to a third party. Transfers of shares by way of gift to members of an insider's family or as collateral in a bona fide loan transaction are permitted, provided the transferee or pledgee also agrees in writing to be bound by the agreement.

(b) *Buyout Provisions*

Some stockholder agreements provide that the company or the venture capital investors or both have an option to purchase the shares of any insider at fair market value upon the occurrence of certain contingencies, such as death, personal bankruptcy, or attachment of shares by legal process, as in the divorce context. Detailed procedures, usually involving one or more appraisals by disinterested persons, are provided to ensure a fair valuation of the stock.

(c) *Right to Participate in Insider Sales*

Although philosophically at odds with a right of first refusal, a stockholder agreement typically provides that the venture capital investors have a right to participate alongside management insiders in any sale to third parties. Although rarely exercised, this cosale or "take-along" right limits management's ability to bail out of the company, thereby leaving the investors at risk to recover their investment.

(d) *Voting Requirements*

All parties will generally agree to vote all shares for the election of directors in favor of specified nominees of the respective groups.

Restrictions under applicable state law need to be examined to determine the legality of stockholder agreements in any given jurisdiction, as well as to verify compliance with state procedural and substantive requirements. Unless otherwise limited by state law, stockholder agreements generally terminate upon the earlier of a public offering by the company or the expiration of a stated period of time.

§ 11.8.2 Employee Incentives

Venture capital investors typically insist that appropriate equity incentives be implemented to attract, retain, and motivate key employees. For the average company with a complete management team, the range is from 5 percent to 15 percent of fully diluted equity. The investment agreement specifies a pool of shares to be set aside for employee purchases and exempts the issuance of those shares from the various negative covenants, antidilution provisions, and rights of first refusal contained in the investment agreement and the terms of the investment securities. Establishment of appropriate employee stock plans is frequently a condition of closing the investment and is usually required to be treated as part of the preinvestment capital of the company, limiting the dilutive effect to the preinvestment stockholders. Incentive objectives and tax considerations play a significant role in determining the shape of an employee incentive program. Among the typical employee equity incentives are the following:

- stock purchase plans, providing for an outright sale to key employees, with the company retaining an option to repurchase the shares at cost on a lapsing basis (generally over three to five years) if the employee's employment terminates for any reason;
- incentive stock options, enabling employees to purchase shares with advantageous tax consequences at the fair market value on the date the option is granted; and
- nonstatutory stock options, which may have exercise prices less than fair market value at the date of grant and other terms not available under incentive stock options. However, since the enactment of I.R.C. § 409A in 2004, it is rare that such options have an exercise price less than fair market value, as such an exercise price would cause the spread between exercise price and fair market value to be included in income on the date when restrictions on the vesting of the options lapse. Further, this "spread" is subject to tax at normal income tax rates for ordinary income and a 20 percent excise tax.

In all circumstances consideration must be given to the application of I.R.C. § 83 to issuances of stock to employees. Section 83(a) provides that an employee is required to recognize income in respect of property, including corporate securities, received in connection with the performance of services in an amount equal to the difference between the fair market value of the property and the amount paid therefor. In the case of property subject to restrictions that lapse over time, such as forfeiture restrictions or repurchase options, the income is recognized at the time the restrictions lapse. Thus, an employee who acquires stock at a low purchase price in the early years of an enterprise, and whose rights to those shares "vest" as forfeiture restrictions lapse over a period of years, recognizes ordinary compensation income based on the appreciated value of those shares as each installment lapses. Importantly, as noted above, compensation income is recognized at vesting even if the employee purchased the shares at fair market value. Section 83(b) ameliorates the harsh effect of this provision by permitting a taxpayer to elect to include the value of the transferred property in income in the year of receipt by filing a Section 83(b) election. In connection with an outright grant, compensation equal to the fair market value of the grant is recognized. In connection with a fair market value purchase, no compensation income is recognized. The ability to transfer equity subject to vesting restrictions for which the compensation element can be closed relatively inexpensively from a tax perspective is a powerful incentive. Also, stock acquired by exercise of an incentive stock option is subject to the provisions of Section 83 only for alternative minimum tax purposes, not regular income tax purposes.

Section 83 is applicable to a founding stockholder of a new company who acquires shares subject to a repurchase option of the company that is exercisable upon termination of the founder's employment prior to the end of a specified period if the repurchase may be at less than the then–fair market value. Consequently, founding stockholders should consider filing Section 83(b) elections when shares are initially acquired if subject to such a repurchase option. If a founder owns shares without any vesting restrictions, and these shares first become subject to vesting in connection with a venture financing, under the authority of IRS Revenue Ruling 2007-49, a Section 83(b) election is not necessary to prevent assessment of tax liabilities when those shares vest at appreciated values in later years. In this ruling the IRS determined that Section 83 is not applicable to the imposition of restrictions on previously unrestricted shares because there is no transfer of property for purposes of Section 83 by virtue of placing restrictions on the shares.

Also, an optionee should consider filing a Section 83(b) election upon exercise of a stock option if the stock acquired upon exercise is subject to forfeiture restrictions or repurchase options (for example, with an early exercisable stock option). If, at the time of the exercise of the stock option, the exercise price is equal to the fair market value of the underlying stock, making the election does not result in any tax liability at the time of the election and may reduce the optionee's overall tax liability. (The reason there is no tax liability upon making the election in this situation is because the new restricted stock is deemed to be purchased at its fair market value with the stock acquired upon the exercise of the option. Therefore, there is no compensation element in the transaction.) However, if the stock option is exercised when the fair market value of the underlying stock is higher than its exercise price, compensation income will be recognized at the time the Section 83(b) election is made with respect to a nonstatutory stock option and an incentive stock option may be subject to alternative minimum tax liability.

Finally, effective in 2018, new Section 83(i) of the Internal Revenue Code allows, upon election by the employee, a delay, for up to five years, of any tax on compensation paid to the employee of certain eligible employers in the form of stock acquired on the exercise of nonqualified options. In general, the conditions required by Section 83(i), including that any equity incentive plan cover at least 80 percent of employees, has stifled the use of this election.

§ 11.8.3 Employee Confidentiality and Proprietary Rights Agreements

Protection and preservation of the "intellectual capital" of an enterprise is of paramount importance to the venture capital investor, especially where the portfolio company is engaged in product development activities on the leading edge of technologies. To secure the company's claim to its valuable proprietary and business rights, investors require that founders and other key employees enter into nondisclosure and invention agreements with the company. These agreements typically provide that the employee

- will not disclose company trade secrets or rights to third parties or use such rights for any purpose, in each case other than in connection with the company's business; and
- will disclose and convey to the company all inventions developed by the employee during the course of employment.

Such agreements often obtain the commitment of the employee to cooperate with the company, even after employment is terminated, to the extent necessary to perfect the company's record ownership of the inventions. In addition, such agreements often contain acknowledgment that the individual is not bound by any obligations to a former employer that would prevent or restrict the employee's employment with the company and that the employee's performance of services for the company does not involve the violation of the proprietary rights of any former employer.

§ 11.8.4 Employment and Noncompetition and Nonsolicitation Agreements

Venture capital investors often want to formalize employment arrangements with key employees in the form of employment letters and noncompetition and nonsolicitation agreements. These agreements generally contain provisions concerning the following:

- term of employment;
- conditions of employment, including salary and other benefits;
- conditions for termination (expiration of the stated term, for "cause"—which generally is narrowly defined—or without cause termination, termination upon death or disability);
- severance pay, if any; and
- noncompetition and nonsolicitation provisions.

It is important to verify that whatever noncompetition provisions are desired are enforceable in the jurisdiction where the employee resides. Certain states severely restrict the ability of companies to enforce noncompetition agreements, and the Federal Trade Commission has expressed its desire for a nationwide ban on most of these agreements. In general, employment agreements benefit the employee rather than the company.

§ 11.8.5 Legal Opinion

The favorable legal opinion of company counsel generally covers the legality of the securities, compliance with state and federal securities laws, and related matters. If the company is involved in litigation, company counsel may be requested to express a position. Likewise, if patents are critical to the company's business, a favorable opinion of patent counsel may also be required. A common error is to confuse the opinion of legal counsel with due diligence. Counsel is not a surety for business or legal uncertainties; the opinion is not a substitute for factual investigation. SEC Rule 10b-5 opinions are generally not given in venture capital financings.

§ 11.9 SUMMARY

Counsel to the company seeking venture capital financing plays a central role in facilitating the venture capital investment process. Many of the concepts, jargon, concerns, and expectations of venture capital investors may be new to the entrepreneur. The process of identifying, courting, negotiating, and maintaining relations with the venture capital fund can be time-consuming and frustrating for the entrepreneur. By educating and supporting the entrepreneur throughout the process, counsel can help ease the often associated frustrations. Further, by focusing attention on matters that are truly of concern to the company and that are open for negotiation, counsel can assist in making the process efficient for both company and investor.

Almost invariably, the investment agreement and other legal documentation of the investment are drafted by counsel for the venture capital fund. The legal documentation involved in venture capital investments typically is extensive, sophisticated, complicated, and increasingly stylized. For those being initiated to this documentation, it can often be difficult to understand how the relatively short term sheet can result in such a lengthy, carefully interwoven set of documents. Counsel should allocate time to work carefully through the documents with the entrepreneur, focusing in particular on the representations and warranties (including any exceptions that need to be reflected) and the covenants undertaken by the company. The investor's counsel expects the company's counsel to provide any schedules required by the investment agreement and to ensure that all actions that are required to be taken prior to the closing have been taken.

Finally, the negotiation and consummation of a venture capital financing set the tone for what all parties expect to be a long-term relationship. Company counsel plays an important role in assuring that the relationship begins well.

This chapter adapts and updates an earlier work entitled "Venture Capital Financing" from Massachusetts Business Lawyering *(MCLE, Inc. 1991 & Supp. 2000, 2005), originally authored by Richard J. Testa (deceased). The chapter's current and successor authors acknowledge Mr. Testa's earlier work and honor his memory. The authors and MCLE are also grateful to Karl P. Fryzel and Richard N. Kimball for their contributions to previous versions of this chapter.*