AN IN-HOUSE COUNSEL'S GUIDE TO

RAISING VENTURE CAPITAL

BY CHRISTOPHER R. RYAN AND JOHN J. MCDONALD

It's Friday at 5 PM, and things are quiet in your office. You know that Friday afternoons are when interesting things often happen in the office, and your instincts are confirmed when your CEO stops by to tell you that he has received informal approval from the board of directors to begin the process of raising money from a venture capital firm. He says that he wants the whole process completed as soon as possible, on terms favorable to the company, and that the venture capital firm's attorney will be contacting you on Monday to discuss a term sheet. The CEO then leaves your office as quickly as he arrived, and after you get a chance to catch your breath, you think to yourself: "Outside counsel will handle this transaction. However, I've never worked on a venture capital deal and I need to show the CEO that I know what I'm doing — now what?"

This article summarizes the venture capital (VC) financing process and the terms that are typically negotiated in connection with venture financings.

The timeline and process for venture capital financing

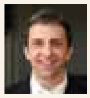
Once your company makes the decision to seek VC financing, the process generally proceeds as follows.

First, your company's management team — typically led by the CEO and CFO — will prepare a business plan to provide to potential VC investors. The business plan will contain enough information about your company's business to pique the VC's interest, but not so much that you don't feel comfortable providing it to the VC without a non-disclosure agreement (NDA) being in place. As a matter of policy, VCs usually refuse to sign NDAs to review business plans, based on the fear of being sued.

Your company's business plan will be provided to the VC, ideally by way of a "warm introduction" through a mutual business contact, attorney, accountant or investment banker who is trusted by the VC. If the VC is interested, the mutual contact will set up an introductory meeting between the VC and your company's management team, which will be followed by the VC doing preliminary due diligence on your company. During this time, the VC will closely analyze your company's business model and projections with members of your company's finance team (often building her own financial model for the company), visit company offices to meet your employees, and possibly talk with some of your customers and suppliers.

At or prior to this point, you are well advised to get your company's "legal house" in order. To be prepared for the VC's legal due diligence request, start by converting to a "C-Corp" (if necessary), drafting any outstanding board and stockholder meeting minutes, and gathering and organizing your company's organizational documents (certificate of incorporation and bylaws), intellectual property documents, employee benefit plans and other employment-related documents, key vendor agreements, and other customer and supplier contracts, as well as any other important company documents.

If the VC is satisfied with the results of its preliminary business due diligence, the VC will proceed with intensive business due diligence of your company, consisting of discussions between the VC and your company's customers and suppliers, and a thorough analysis of your company's technology, which in some cases, the VC may outsource to a consultant. At this point in the due diligence process, the VC and its consultant (if applicable) will typically agree to sign an NDA restricting their use of company information learned in the course of the process.



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If the VC's intensive due diligence yields no issues and it decides to proceed with an investment in your company, the VC will pitch the investment to her investment committee and obtain its approval to "proceed to term sheet." Term sheets vary considerably in scope — some list only a few key investment terms (investment amount, type of security purchased and valuation), while others go into considerably more detail, specifying virtually all of the investment terms. A "narrow" term sheet with only a few key terms can help get the process started quickly, but will result in heavier negotiation of the definitive investment documents, which may surface differences of opinion between the company and the VC on key deal terms that cannot be reconciled. This can result in the investment failing to close after the parties have incurred significant legal and other expenses (in addition to its own expenses, the company usually pays the VC's expenses, regardless of whether the investment closes). By contrast, a "comprehensive" term sheet will "front load" the negotiation process concerning the key deal terms, making it more likely that the deal falls apart early on. However, once the term sheet is finalized, implementing the deal through the definitive investment documents will be quicker, and the transaction will have greater certainty of closing.

The next step is the VC preparing and supplying to your company the initial draft term sheet. Once the term sheet is negotiated, finalized and signed by the parties, the exclusivity period in the term sheet (often 45-90 days) will start, and your company will cease discussions with any other VCs concerning potential investments. Although term sheets are not "legally binding," VCs will react extremely negatively to any significant deviation from the term sheet proposed by company management in the course of negotiating the definitive investment documents. It will be viewed as an attempt by the company to "re-cut the deal" after the VC has obtained approval from her investment committee. This could harm the VC/company relationship or even derail the investment process entirely. As a result, it is prudent to involve legal counsel experienced in venture capital financings at the term-sheet stage, rather than being brought in later, when the definitive investment documents are being negotiated by the parties.

Using the agreed-upon provisions from the signed term sheet as the guide, the VC's lawyer will then prepare and present to your company drafts of the definitive investment documents (i.e., stock purchase agreement, investor rights agreement, stockholders agreement and certificate of incorporation). Negotiation by the parties will then follow concerning matters that were either not addressed in the term sheet or were identified in the VC's due diligence process, resulting in final investment documents. Upon signing the documents, the VC will wire the funds to the company.

The VC financing process can take as little as one to two months, but typically takes three to six months from start to finish. It is not uncommon for a very attractive company to negotiate term sheets simultaneously with more than one VC firm, up to the time that the company signs a term sheet "giving exclusivity" to one of the VCs.

Key investment terms

Like any other commercial transaction, there are different approaches to each of the key terms of venture capital financings — some approaches are favorable to the VC, while others are more favorable to the company. The VC will usually propose the more VC-favorable approaches in its initial drafts of the term sheet and the definitive investment documents, which will then get negotiated by the company. Briefly described below are each of the key investment terms in VC financings, as well as the VC- and company-favorable approaches to each.

Valuation. Valuation of the company determines what percentage of your company's equity the VC receives for its money — the higher the valuation, the lower the percentage, and vice versa. Typically referred to as the "pre–money valuation," this is one of the most hotly contested issues in venture financing.

- Company-favorable approach: Since a higher valuation will result in the VC receiving a smaller percentage interest in your company, leaving more for your company's existing equity holders (i.e., management and previous investors), a higher valuation is more company-favorable.
- VC-favorable approach: A lower valuation will result in the VC receiving a larger percentage interest in your company, which the VC will often argue is necessary compensation for the risk it is taking in making the investment.

The VC will usually base its proposed valuation of your company on its experience with other companies in similar businesses. Although there are technical methods for calculating valuation, including multiples of revenue, and EBITDA and "comparable company" analyses (start with the value of comparable public companies and apply a discount), valuation is usually more art than science in practice. Your company's best leverage in obtaining a higher valuation from a VC is competition from other VCs willing to invest at a higher valuation.

Ownership and valuation are typically calculated on a "fully diluted" basis, meaning that all securities that can be converted into, or exercised for, shares of common stock (including convertible notes, preferred stock, options and warrants) are counted. The calculation usually includes a fixed amount of shares reserved for existing and future stock options, and restricted stock grants to employees, directors and consultants under your company's equity incentive plan (the "option pool"). VCs will sometimes propose that your company's existing stockholders bear the full brunt of the option pool by calculating its share number, assuming issuance of the full option pool. However, the more company-favorable approach is to make future option pool issuances dilute all company stockholders' stakes, including that of the VC.

Dividends and liquidation preference. VCs invest in emerging growth companies for capital appreciation potential, not to receive periodic dividends, and such companies rarely actually issue any dividends. However, preferred stock dividends are important because they are used in calculating the "liquidation preference," which protects the VC's downside by ensuring that the preferred stockholder (the VC) receives the proceeds from a sale or liquidation of your company before common stockholders (management) receive anything. The liquidation preference is usually equal to the original purchase price plus the accrued and unpaid dividends on the preferred stock. Accrual of preferred stock dividends works like interest accruing on debt — a stated percentage of the original purchase price of the preferred stock (e.g., 8 percent) accrues every year until the sale or liquidation of your company, or the redemption or conversion of the preferred stock. Dividend accrual can be "simple interest" or "compounding," with the former being more company-favorable.

- Company-favorable approach: A company-favorable approach to the liquidation preference is for the preferred stockholders to receive upon sale or liquidation of the company the greater of either: (1) original purchase price plus accrued but unpaid dividends, or (2) the amount receivable in the sale or liquidation with respect to the shares of common stock for which the preferred stock is convertible.
- VC-favorable approach: A more VC-favorable approach to the liquidation preference is a so-called "participating preferred" or "double dip" provision, under which the preferred stockholders receive both: (1) original purchase price plus accrued but unpaid dividends, and (2) the amount receivable in the sale or liquidation with respect to the shares of common stock, for which the preferred stock is convertible. This is called a "participation feature"

Key Terms to Know When Raising Venture Capital

DOUBLE-DIP: The preferred stock issued to the VC receives, upon sale or liquidation of the company, both its "liquidation preference," and the amount receivable upon conversion of the preferred into common stock.

FULL-RATCHET: If your company subsequently does a dilutive financing, the VC's preferred stock gets an anti-dilution adjustment to become convertible into more shares of common stock. Unlike a "weighted average" anti-dilution adjustment, with "full ratchet" anti-dilution, the conversion ratio adjustment isn't dependent on the number of shares sold in the dilutive financing — it is the same regardless of whether 10 shares or 10,000,000 shares are sold.

LIQUIDATION PREFERENCE: The VC will receive a specified amount (usually original purchase price plus accrued dividends) on its preferred stock before the common stockholders (management) receive any proceeds in connection with a sale or liquidation of the company, and if the sale proceeds are less than the liquidation preference amount, the VC gets all of such proceeds and management gets nothing.

PAY-TO-PLAY: A group of VCs making an investment in a company agree that failure by any of them to support the company by participating pro rata in subsequent investment rounds will result in such VC being penalized through adverse changes to the terms of its existing preferred stock.

PRE-MONEY: The pre-money valuation determines the percentage of your company's equity that the VC will receive in the financing. A $7 million pre-money valuation on a $3 million VC investment equals $10 million post-money valuation (including the invested funds), and a 30 percent interest to the VC.

TAGS AND DRAGS: The VC gets the right to sell its company stock along with any company stock sold by management (tag-along or co-sale rights), and to form a group with other company stockholders that together hold at least a majority of the outstanding company stock, which can force the minority stockholders to participate in a sale of the company transaction (drag-along right).

TERM SHEET: The document listing the key investment terms that is negotiated by the VC and the company.

because the preferred stock "participates" with the common stock on an as-converted basis. Sometimes, a participation feature is used, but the resulting total liquidation preference amount is capped at a multiple of the original purchase price of the preferred stock, as a way of making it friendlier to the (management) common stockholders. The most VC-favorable approach is for the preferred stockholders to receive a liquidation preference amount that is a multiple of the original purchase price, plus accrued but unpaid dividends (usually "2x" or "3x"), in addition to the participation feature, which makes it less likely that the (management) common stockholders will receive anything for their shares upon a sale or liquidation of the company. For this reason, "liquidation preference multiples" are typically only found in situations in which the company is in dire need of financing and the VC has very strong negotiating power.

If your company has multiple series of preferred stock outstanding (Series A, Series B, etc.), there will be an established ranking for purposes of payment of dividends and liquidation preference amounts in which each series of preferred stock will either be "senior" to, "junior" to, or "pari passu" (equal rank) with the other series of preferred stock. Whether a new series of preferred stock issued in a VC financing will be senior to, junior to, or pari passu with the existing series of preferred stock is usually a hotly negotiated issue between the VC providing the financing and the existing preferred stockholders. Management, however. will usually be indifferent as all preferred stock will be senior to the common stock held by management.

Conversion rights. Preferred stock issued in VC financings is usually convertible into shares of common stock, which gives the VCs an "upside" benefit if your company does well and the value of its common stock increases dramatically. The conversion ratio is usually initially set at 1:1, and is subject to adjustment in connection with subsequent dilutive stock issuances through the anti-dilution protection provision (discussed below).

Preferred stock is usually convertible into common stock at any time after issuance, at the VC's option, although the VC will typically only convert into common stock upon a sale transaction (and then only if doing so will result in greater sale proceeds than it would receive as a preferred stockholder). The preferred stock usually converts automatically into common stock if your company goes public at a valuation that provides a sufficient return to the VC. A "Qualifying IPO" is an initial public offering: (1) that results in at least a specified amount of net proceeds to the company (usually $25-40 million), and (2) in which the company's common stock is sold for at least a specified per-share price — usually 3-5 times the per-share preferred stock price paid by the VC.

Anti-dilution protection. Preferred stock issued in VC financings usually has "anti-dilution" protection, which protects holders from the dilutive effect of future issuances by your company of securities, at a lower valuation than was used in the VC financing. (Such investments are considered "dilutive" because the later investors receive stock representing a greater percentage of your company for less money, on a per-share basis, than was paid by the current investors.)

Anti-dilution protection applies not only to stock issuances, but also to issuances of promissory notes, options and warrants that are convertible into, or exercisable for, shares of your company's stock.

Anti-dilution protection is implemented by adjusting the ratio at which the preferred stock is convertible into shares of common stock (which, as noted above, is usually initially set at 1:1). This means it becomes convertible into more shares of common stock if your company does a subsequent dilutive issuance, increasing the "as converted" percentage interest of such preferred stock to counteract the effect of the dilutive issuance.

- Company-favorable approach: The most company-favorable approach is "weighted average" anti-dilution protection that is "broad-based." Unlike "full ratchet" anti-dilution protection, in which the preferred stock conversion ratio adjusts in response to the dilutive securities issuance regardless of the amount of securities sold in the dilutive issuance (i.e., the adjustment is the same whether your company sells 100 shares or 10,000,000 shares in the dilutive issuance), "weighted average" anti-dilution protection adjusts the preferred stock conversion ratio according to the number of shares sold in the dilutive issuance. This approach is more fair to management and other existing stockholders since it more accurately counteracts the actual dilution resulting from the dilutive issuance. It does this rather than giving the preferred stockholder a windfall if your company subsequently issues securities at a lower valuation, even if that subsequent securities issuance is so small — as compared to the investment made by the preferred stockholder — that it doesn't meaningfully dilute the preferred stockholder. Weighted average anti-dilution provisions can be either "broad-based" or "narrow-based," with the broad-based version using a larger denominator in the calculation, including stock options and warrants (in addition to outstanding preferred and common stock). This results in a smaller anti-dilution adjustment for a given dilutive securities issuance, as compared to a narrow-based version.
- VC-favorable approach: As noted above, the most VC-favorable approach is "full ratchet" anti-dilution protection. If "weighted average" anti-dilution protection is used, the narrow-based version is more VC-favorable than the wide-based version.

There are usually "carve outs" from anti-dilution protection for issuances of stock options and restricted stock pursuant to your company's equity incentive plan, issuances of warrants to lenders and landlords, and issuances of stock by your company in connection with corporate acquisitions and other strategic transactions, based on the idea that these issuances do not warrant anti-dilution protection because they increase the value of the VC's investment. It is more VC-favorable to have a shorter list of "carve outs" and to include numerical caps on the amount of shares that may be issued under each "carve out" category.

Voting rights. The VC will usually require that your company obtain its consent to take certain actions as long as the preferred stock that the VC receives in the financing is outstanding. The consent rights typically relate to either "capitalization-related" actions or "operations-related" actions.

The most important of the capitalization-related VC consent rights restricts your company's ability to subsequently create or issue any new series of preferred stock that is senior to, or pari passu (equal rank) with, the preferred stock sold to the VC. This effectively gives the VC a veto on any future equity financings of your company, since a new investor is not going to agree to make its "new money" junior to the money previously invested in your company. If anything, the "new money" is usually senior to "old money." As a result, it is more company-favorable to make this VC consent right apply only to future issuances of preferred stock that is senior to the preferred stock sold to the VC, thereby allowing your company to issue junior or (more importantly) pari passu preferred stock in the future without the VC's consent. Another important capitalization-related VC consent right restricts your company's ability to amend its certificate of incorporation or bylaws to adversely change the rights, preferences and privileges of the preferred stock sold to the VC. However, this is a standard provision that is not typically negotiated by the parties. The scope of operations-related VC consent rights can vary considerably, but usually include significant matters like selling the company, hiring or firing members of senior management, incurring debt (other than trade payables), making capital expenditures, establishing the annual budget, changing the company's business and entering into related-party contracts. Some VCs who have been burned in past investments will try to limit their risk by proposing a very comprehensive package of operations-related VC consent rights, but doing so can significantly hamper management's ability to run the business.

In addition to capitalization and operations-related VC consent rights, the VC usually receives the right to appoint one or more members of your company's board of directors, and to have those persons be members of key board committees like the audit and compensation committees. Sometimes, board appointment rights are conditioned on the VC maintaining at least a specified percentage interest in your company by participating in subsequent financing rounds. Board composition is typically adjusted in connection with each financing round as representatives of the new investors are added to the board and earlier round investors agree to reduce the number of their board representatives so that the board's size does not become unwieldy.

Pre-emptive rights. The VC usually receives contractual pre-emptive rights to participate in future equity financings of your company. thereby maintaining its percentage interest by purchasing its *pro rata* portion of the equity securities sold in any subsequent financing. This is subject to "carve outs" for certain equity issuances that are not considered to be dilutive to the VC's investment because they increase the value of the VC's investment. These are often the same as the "carve outs" from the anti-dilution provision discussed above.

Redemption rights. Preferred stock issued in VC financings usually includes a redemption right in which your company is required to buy the preferred stock back from the VC, upon their request, at any time after a specified time period has elapsed after closing of the VC financing (usually 5-7 years). This is a way for the VC to force an exit from its investment in your company if your company hasn't been sold or done its initial public offering by then.

- Company-favorable approach: The more company-favorable approach is for the redemption price to be the "liquidation preference" amount (original purchase price plus accrued and unpaid dividends) and to not include any penalty if your company does not have sufficient funds to be able to redeem the preferred stock when requested by the VC.
- VC-favorable approach: The more VC-favorable approach is for the redemption price to be the greater of: (1) the liquidation preference amount, or (2) the fair market value of the preferred stock as of the time of redemption (which is usually based mostly on the then-current value of the common stock into which the preferred stock is convertible), and to include penalties if your company does not have sufficient funds to redeem the preferred stock when requested by the VC.

Right of first refusal and co-sale rights. The VC will usually want to ensure that company stock does not go outside of "friendly hands" by requiring management (and sometimes prior investors) to offer their company stock back first to the company and then to the VC, prior to transferring it to any third party, at the same price as proposed to be paid by the third-party buyer (a "right of first refusal"). If the company and the VC don't fully exercise their first refusal rights concerning a proposed stock transfer by management (and sometimes prior investors), the VC will typically require that the transferor allow the VC to participate in such transfer by requiring the buyer to also buy a *pro rata* portion of the VC's stock (co-sale or tag-along rights). If the buyer refuses to buy all of the shares proposed to be transferred by the transferor, as well as those of the VC, the transferor will usually be required to reduce the amount of stock that it transfers in the sale so that the VC can sell its *pro rata* portion.

- Company-favorable approach: The more company-favorable approach is to make the right of first refusal "all or nothing" (i.e., the company and the VC must collectively buy all of the stock proposed to be transferred or they don't have the right to buy any of such stock) and to include "carve outs" from right of first refusal and co-sale provisions for: (1) transfer of any company stock that was purchased for value (as opposed to having been issued for free as an equity incentive), (2) transfers among the employee stockholders, (3) transfers of up to a specified amount of stock per year, and (4) estate-planning-related transfers to family members and trusts established for their benefit.
- VC-favorable approach: The more VC-favorable approach is to give the company and the VC the right to purchase any of the stock proposed to be transferred, to make the right of first refusal run first to the VC and then to the company (rather than vice versa), and to not include the first three "carve outs" listed above. (The "carve out" for estate-planning-related transfers is customary and usually not controversial.)

Drag-along rights. To help ensure their ability to exit the investment, VCs sometimes subject minority stockholders (i.e., management and prior investors) to a drag-along provision, in which the VC and other company stockholders collectively holding at least a specified percentage of the company's stock can force the minority stockholders to sell their shares, waive dissenters' rights and take other actions in support of the sale transaction. It is usually a requirement for the drag-along sale that minority stockholders receive the same price and other sale terms as the majority stockholders (i.e., no "control premium" is paid to the majority stockholders).

- Company-favorable approach: The more company-favorable approach is to require that the company's board of directors (in addition to the majority stockholders) approve a drag-along sale. It is also more company-favorable to require "supermajority" stockholder approval (i.e., from two-thirds to 85 percent in interest) to initiate a drag-along sale — rather than a simple majority in interest (50.1 percent) — since the higher percentage threshold can give a group of minority investors (such as management and some other minority investors) the ability to act together to block a drag-along sale.
- VC-favorable approach: The more VC-favorable approach is to not require board approval and to require only a simple majority in interest of stockholders to initiate a drag-along sale.

Registration rights. The VC will typically receive registration rights, under which your company is required to register the common stock received upon conversion of the VC's preferred stock with the SEC for sale in a public offering, either as part of an SEC-registered offering already planned by the company ("piggyback" registration rights) or in an SEC-registered offering initiated at the VC's request ("demand" registration rights), in each case, at your company's expense.

- Company-favorable approach: The more company-favorable approach is to tie the demand registration to a specified time period after the company does its IPO (typically 60-90 days), rather than making it a "forced IPO" provision in which the demand right is tied to the closing date of the VC financing (regardless of whether your company has gone public by then), which will effectively require your company to go public by the specified date or obtain a waiver from the VC. Forced IPO provisions are objectionable because a company's ability to go public is driven to a significant degree by the state of the public securities markets, which are not controlled by the company or the VC investors, and may not be hospitable to an IPO at a particular time.
- VC-favorable approach: The "forced IPO" approach described above (usually 5-7 years after the investment closing) is more VC-favorable, as are a larger number of demand registration rights (two or three is a typical number) and a "most favored nation" provision restricting your company's ability to subsequently grant registration rights to others on more advantageous terms.

The process of raising venture capital presents an excellent opportunity for in-house counsel to play a key role in a critical event in any company's life cycle. In other words, it's your time to shine, and just because you may not have experience with the VC process, it does not mean that you cannot add value. Working in conjunction with outside counsel, it is your job to avoid unnecessarily agreeing to terms that may come back to haunt your company months or even years down the road. Finally, remember that you will likely be the "go to" person with questions from management regarding the deal documents in the future. Therefore, it will be a productive use of your time to understand the meaning and underlying rationale of all the terms of your VC deal.

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