Driving Business Advantage

Angel and Venture Capital Critical Deal Terms

Presentation for
TCN: The Capital Network

Emerging Enterprise Center at Foley Hoag

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Introductions

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–Partner at Foley Hoag and Deputy Chair of the firm's Business Department.

–Practice focuses on venture capital financings, M&A, strategic alliances and related business transactions.

–Has helped clients raise hundreds of millions of dollars in angel and venture capital, and has advised clients through dozens of acquisitions and public offerings.

Overview

- Reference Materials (1 min.)
- Entrepreneur and Investor Concerns (4 min.)
- Critical Deal Terms (50 min.)
- Negotiating Tips (5 min.)
- Questions (30 min.)

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Reference Materials

- Foley Hoag Glossary of Commonly Used Terms
- NVCA Model Venture Capital Financing Documents:
  - www.nvca.org/model_documents_/model_docs.html

- Note: Forms are intended as <u>starting point only</u>

General Trends

- Raising capital in the last 12-18 months is significantly more difficult than the first half of 2008
- Valuations are way down, deals take more time, terms are less favorable to companies and founders
- Tranches based on achievement of value-enhancing milestones are back in vogue
- Syndicates are becoming more desirable to investors, but harder to create
- Cash burn is squeezing out promising enterprises

Entrepreneur's Main Concerns

- Loss of control over company
- Dilutive impact on common stock, including your personal equity position
- Risk of forfeiture of your stock if employment is terminated, or if you retire or resign
- Adequacy of financing amount
- Future capital needs and dilution
- If debt is sold, is there a security interest in key assets of company
- Success of partnership with angels and VCs – access to key industry contacts, future $, business guidance

Investors' Main Concerns

- Accuracy of valuation (both present and projected)
- Appropriate level of risk in this investment
- Ability to achieve liquidity
- Ability to participate in later rounds
- Influence and control over management and strategic direction

Critical Deal Terms - General Concepts

- Deal Economics
- Monitoring and Preserving Investment
- Control of Company
- Maintaining / Increasing Equity Position
- Liquidity

Key Terms

- Economics of the Deal
  - Form of Investment
  - “Pre-Money Valuation”
  - Option Pool Reserve
  - Dividends
  - Liquidation Preference
  - Anti-Dilution Protection
  - Vesting of founders’ stock

Key Terms - Form of Investment

- Why Convertible Preferred Stock?

  - "Preferred" - Preference over common stock on dividends, distributions, liquidation, redemption

  - "Convertible" - All of the upside of common stock

- Alternative – Convertible Debt with Warrants
  - Advantages: Simple documentation, quicker, cheaper, delays valuation
  - Disadvantages: Misaligns incentives (note holders want lower valuation in preferred stock round), sometimes have aggressive terms, impact on balance sheet

Pre Money Valuation

- "Pre-Money Valuation" is the value given to the company before the new capital comes in. It allows us to calculate the price of the new shares:

  Share Price = Pre-money Valuation / ***Pre-money Shares Outstanding***

- Critical Issue – the higher the number of shares deemed "outstanding," the higher the number of shares that the investors receive for the same dollar amount of investment.

Pre Money Valuation

	Example 1	Example 2
Pre-Money Valuation	$10,000,000	$10,000,000
Shares Outstanding	÷ 7,500,000	÷ 10,000,000
Price Per Share	$1.3333	$1.00
Shares Issued for $5M	3,750,000	5,000,000
Percentage of New Shares	33%	33%

Pre Money Valuation

- Keep your eye on the ball- try to focus on percentages, not share numbers.
- Focus on what shares are being counted in the "Shares Outstanding" number? (All outstanding options? Options reserved under the option pool? What is the size of the option pool?)

Term Sheet Language

- Pre Money Valuation and Option Pool

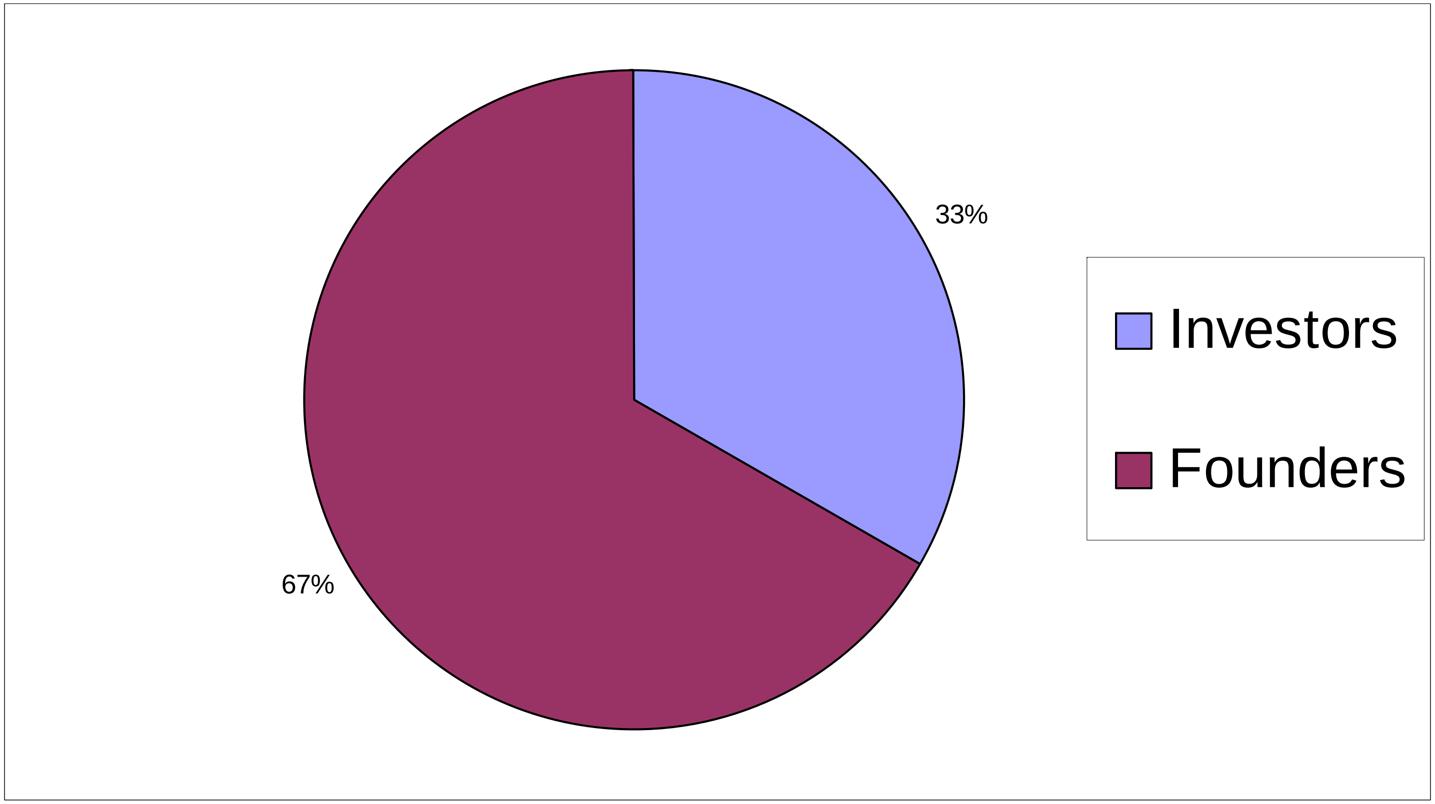
"Pre Money Valuation: The Per Share Purchase Price will be $____, which is based upon a fully-diluted pre-money valuation of $10 million and a fully diluted post-money valuation of $15 million (including an employee pool representing 20% of the fully diluted post-money capitalization)."

Term Sheet Language

- "Fully-diluted" capitalization usually includes:
  - (1) all outstanding common stock,
  - (2) all outstanding preferred stock (on an as converted to common basis),
  - (3) all outstanding options,
  - (4) all shares reserved under the option pool,
  - (5) all outstanding warrants (on an as exercised and as converted to common basis),
  - (6) all other convertible securities on an as converted to common basis.
- "Fully-diluted" does not include shares that are authorized but unissued (other than those reserved for issuance above.)
- Biggest sticking point is the <u>size of the option pool</u>

Key Terms – Pre Money Valuation

- Pre Money Valuation (Without Option Pool)
- $5M investment w/ $10M Pre-Money Valuation



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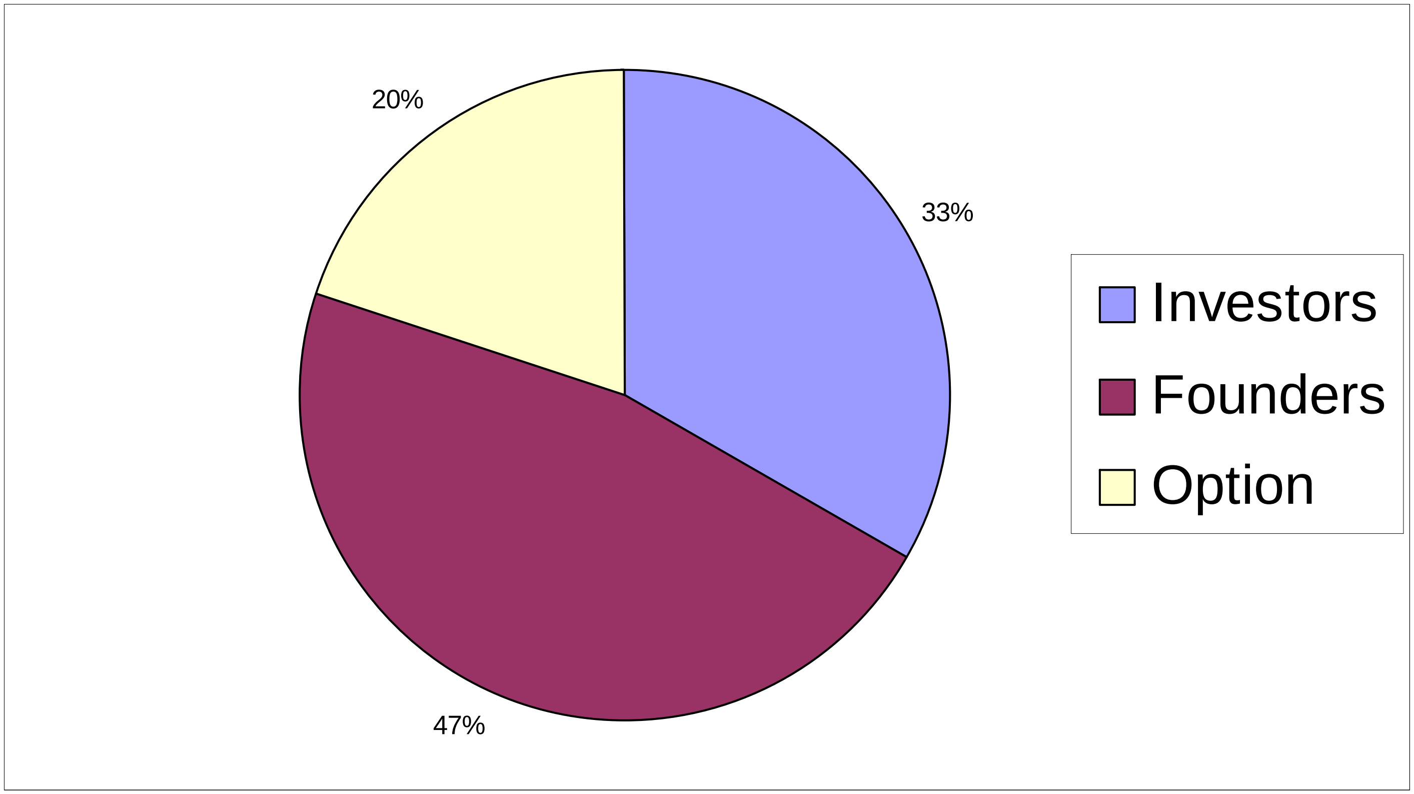

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Liquidation Preference

- Liquidation preference = a feature of the preferred stock giving the holders the right to get their money back (and perhaps more) before the common stock in the context of a "liquidation event." Sometimes "multiples" are used.

- "Preference overhang" is the aggregate amount of liquidation proceeds that go to the holders of preferred stock before the holders of the common stock begin to share in the liquidation proceeds.

- Keep in mind: preferred holders always receive the greater of their liquidation preference or what they would receive if they converted to common stock immediately prior to the preference.

- Only matters in a "liquidation event" (generally M&A).   Not IPO.

"Participating Preferred"

- A type of liquidation preference.
- Participating Preferred is where the holder of preferred stock has a right to get their money back before the common stock (the "preference" part), and then participate on an as-converted to common stock basis as though they owned common stock (the "participation" part).
- Participating Preferred has the effect of re-allocating a significant portion of the company's liquidation value from the common to the preferred.

"Participating Preferred"

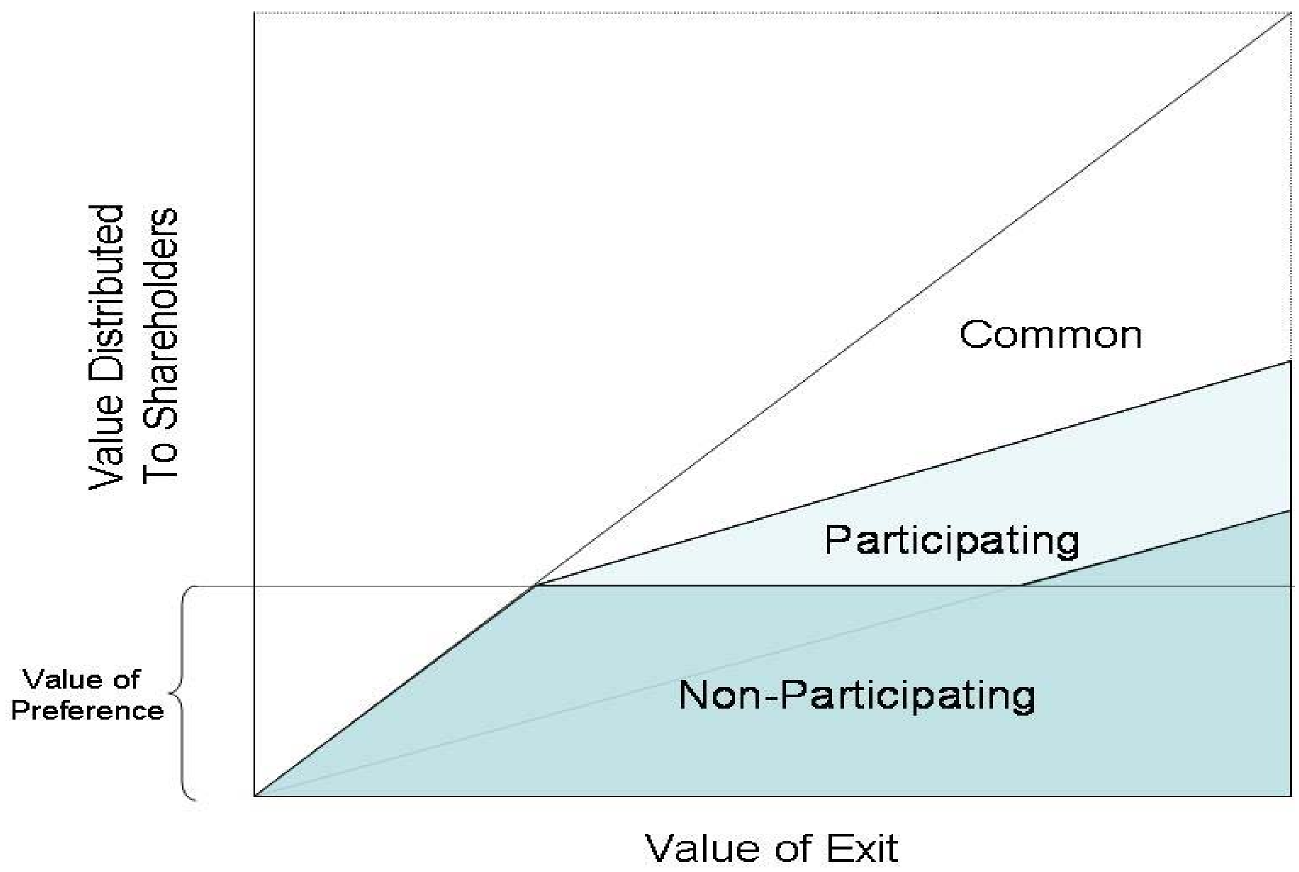
"In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

- ***Alternative 1 (Non-Participating Preferred Stock)*****:** "First pay [one] times the Original Purchase Price [plus accrued/declared by unpaid dividends] on each share of Series A Preferred. Thereafter, the balance of any proceeds shall be distributed pro rata to holders of Common Stock."
- ***Alternative 2 (Participating Preferred Stock)*****:** "First pay [one] times the Original Purchase Price [plus accrued/declared by unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis."
- ***Alternative 3 (Participating Preferred Stock with Cap)*****:** "First pay [one] times the Original Purchase Price [plus accrued/declared by unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock on an as-converted basis until the holders of Series A Preferred receive an aggregate of [two] times the Original Purchase Price."

Example of Liquidation Preferences

- Assume a $5m Series A investment at $20m pre-money valuation (resulting in the Series A investors owning 20% of the company). The company is sold for $40m without any additional shares issued after the Series A investment.
- A "1X Non-Participating Preferred" means the Series A investors get the greater of their $5m back or what they would receive if they converted to common (i.e., 20% of $40m, or $8m). *Result*: $8m of the liquidation amount goes to the Series A and $32m goes to the common stock.
- A "1X Participating Preferred" means the Series A get their $5m back first (the "preferred") and then get 20% of the remaining $35m, or $7m (the "participating"). *Result*: $12m of the liquidation amount goes to the Series A and $28m goes to the common stock.
- A "1X Participating Preferred with a 2X Cap" means the Series A get their $5m back and then get 20% of the remaining $35m up to a total 2X cap (2 times their $5m investment, or $10m). *Result*: $10m of the liquidation amount goes to the Series A and $30m goes to the common stock.
- *Note*: In the case of 1X Non-Participating Preferred, the Series A receive the equivalent of 20% of the total $40m, as compared to the 25% received by the Participating 2X Cap and the 30% received by the Participating Preferred No Cap.

Liquidation Preference



Source: www.wikipedia.org

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Liquidation Preference – Take Aways

- Calculating Liquidation Preference gets VERY complicated, especially when there are multiple rounds of preferred. Some methods:

  Pro Rata Method (Series A, Series B and Series C share together on an as converted basis, then common)

  Tiered Method (Series C take the first bite, then B, then A, etc.)

  Hybrid Method (Series C first, then B and A share pro rata, then common)
- Participating Preferred is almost <u>always</u> negotiable (basic liquidation preference almost <u>never</u> is).
- If participating preferred, always negotiate a cap on preference.
- Liquidation Preference becomes less meaningful in very large exit events, and Participating Preferred is meaningless in very small exit events.
- Problem of "flat spots."
- Early round investors often regret having received very rich terms, as these set a precedent for later rounds.

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Anti-Dilution Protection

- Addresses Investors' concern re: valuation
- Used to calculate the number of shares of common stock issued when a share of preferred stock converts
- Helps protect investors in the case of a "down round," when new money comes in at a total pre-money valuation (or price per share) that is lower than the previous round's post-money valuation.

Full Ratchet

- The conversion ratio of the protected preferred stock is “ratcheted down” to the lowest price at which securities are sold in the down-round. This applies <u>even if only one share is sold</u>.
- Very onerous, and increasingly less common (although lately making a comeback).

Weighted Average

- Takes into account the proportional relevance (or weight) of each component in the calculation rather than treating each component similarly.
- Sometimes formulated as "broad-based" and sometimes as "narrowly-based." ("narrowly-based is more favorable to the protected preferred stock.)
- More common than full ratchet, and much less onerous to un-protected stockholders.

Anti-Dilution - Negotiating Tips

- Down Round Disaster - Common shareholders are diluted twice when a down round closes: first as a result of the normal dilution occurring whenever additional shares are issued, and second as a result of the adjustment protecting the Series A shareholders.
- Avoid confusion: anti-dilution protection refers to the adjustment of the "conversion price" for the Series A; we are not actually issuing more shares of Series A. For this reason, the terms "anti-dilution provisions" and "conversion price adjustment“ are interchangeable.
- Anti-dilution protection is in virtually every angel and venture transaction. Forget about removing it; instead, focus on minimizing its impact.
- In general, resist full ratchet anti-dilution unless your back is completely against the wall.
- Pay close attention to the carve-outs.

Key Terms

- Monitoring and Preserving Investment
  - Board Representation
  - "Affirmative" Covenants
  - Financial Reporting Requirements/ Access Rights
  - Board Observer Rights

Board of Directors

- Purpose: Control the company, monitor investment, comply with federal tax statutes applicable to many VC funds.
- Typical formulation:

  Board of Directors: At the Closing, the Board shall consist of [______] members comprised of (i) [Name] as [the representative designated by [_____], as the lead Investor, (ii) [Name] as the representative designated by the remaining Investors, (iii) [Name] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [___] person(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].

- “CEO Director”.
- “Board Observer” option.

Key Terms

- Maintaining Equity Position

  - Pre-Emptive Rights

  - Right of First Refusal on founders' stock (in addition to founder's stock vesting)

  - "Pay to Play"

- Control

  - "Protective Provisions" (aka Negative Covenants)

  - Blocking rights at Board level and Stockholder level

Protective Provisions

- Veto rights that investors have on certain corporate actions.
- Typical formulation:

  "Protective Provisions: So long as [insert fixed number, or %, or "any"] shares of Series A Preferred are outstanding, the Company will not, without the written consent of the holders of at least [__]% of the Company's Series A Preferred: (i) liquidate, dissolve or wind up the affairs of the Company; (ii) amend, alter, or repeal any provision of the Certificate of Incorporation or Bylaws; (iii) create or issue any other security having rights, preferences or privileges senior to or on parity with the Series A Preferred, or increase the authorized number of shares of Series A Preferred; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred; (v) create any debt security [if the Company's aggregate indebtedness would exceed $[____][other than equipment leases or bank lines of credit][other than debt with no equity feature][unless such debt security has received the prior approval of the Board of Directors, including the approval of [________] Series A Director(s)]; (vi) increase or decrease the size of the Board."

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Protective Provisions - Tips

- Try to limit these as much as possible.
- “Material” qualifiers are not a silver bullet.
- Where possible, try to add the consent of Preferred Stock director as part of the exceptions.
- Resist efforts to have different provisions for different rounds of investment.
- By wary of onerous thresholds: “…without the consent of 90% of the Series A Preferred…”
- Note the overlap with other provisions (e.g. exceptions to anti-dilution protection).

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Key Terms

- Liquidity
  - Drag-Along Rights
  - Tag-Along (Co-Sale) Rights
  - Registration Rights
  - Redemption Rights

Final Thoughts

- This gets very complicated very quickly. Choose your legal counsel wisely, and early!
- Always involve legal counsel before beginning to negotiate these terms.
- Choose your investors (especially your early investors) wisely.
- Choose your fights wisely. Make sure you know what really matters to you, and understand the market dynamics. (Do you really care about redemption rights? Registration rights?)
- Focus on the big picture.

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