VENTURE CAPITAL FINANCING CLASS LEADERS: SABASTIAN V. NILES & ANTONIA HYMAN

Student Presenter:

Alexis Castillo

EQUITY SECURITIES

Equity: Represents an ownership interest in the issuing corporation

Preferred Stock: The stock has priority over another equity security with respect to payments of dividends or the distribution of assets on liquidation of the corporation

Classes: Different types of stock which can be divided further into “series”

Charter: Document that must set forth the special powers, preferences, and rights of a particular class distinguishing one class from another and their corresponding rights

PREFERRED STOCK

- Has special rights regarding voting and conversion into common stock, as applicable
- Redemption Rights
  - Must be written into the charter
  - Usually written in relation to and in distinction from other rights
- Rights in the charter must apply to all class holders. A contractual right, however, is personal only applicable to that stockholder

DIVIDENDS

- Definition: a distribution by a corporation of its stock, cash, or other property on a proportionate basis to its shareholders
- Restrictions:
  - Restrictions are imposed by state law and should be carefully complied with
  - After payment of dividends, a corporation must be in a financial standing that allows it to meet other obligations as they come up.
  - The purpose is to protect creditors

DIVIDENDS TERMINOLOGY

Declared

- Board of directors of a company has obligated itself to pay a dividend

Paid

- Funds get distributed at a future date set by the board at the time of declaration

Accrued

- A dividend that is declared but not paid
- Cumulative dividends can be accrued without being declared

DIVIDEND PROVISIONS

Investor Favorable	Middle of the Road	Company Favorable
The holders of the Series [A] Preferred shall be entitled to receive cumulative dividends in preference to any dividend on the Common Stock at the rate of 15 percent of the Original Purchase Price per annum, when and as declared by the Board of Directors.	The holders of the Series [A] Preferred shall be entitled to receive non-cumulative dividends in preference to any dividend on the Common Stock at the rate of 8 percent of the Original Purchase Price per annum, when and as declared by the Board of Directors. The Series [A] Preferred also will participate pro rata in any dividends paid on the Common Stock on an as-converted basis.	The holders of the Series [A] Preferred shall be entitled to receive non-cumulative dividends in preference to any dividend on the Common Stock at the rate of 8 percent of the Original Purchase Price per annum, as and if declared by the Board of Directors.

PREFERRED STOCK

- Priority Preference: Some percentage of the original purchase price of the preferred stock prior to any dividend payment to the holders of common stock
- "When, as and if declared" Clause
- Preferred stock is essentially a supersized common stock
- Preferred stock is represented by the dividend participation right when has the separate right to share in any dividend paid on the common stock

LIQUIDATION PREFERENCE

Primary Purpose: Allow preferred stockholders to get back their invested funds on a sale of the business before equity stockholders are paid any amount

Priority right

- Based on the original purchase price of the preferred stock, plus accrued but unpaid dividends

Participation right

- Based on the number of common stock shares issuable upon conversion of the preferred stock

LIQUIDATION PREFERENCE PROVISIONS

Investor Favorable

In the event of any liquidation or winding up of the Company, the holders of the Series [A] Preferred shall be entitled to receive in preference to the holders of the Common Stock a total liquidation amount equal to [three] times the Original Purchase price per share plus any declared but unpaid dividends (the "Liquidation Preference"). After the payment of the Liquidation Preference to the holders of the Series [A] Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series [A] Preferred on an as converted basis. A merger, acquisition, sale of voting control, or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed a liquidation.

Middle of the Road

In the event of any liquidation or winding up of the Company, the holders of the Series [A] Preferred shall be entitled to receive in preference to the holders of the Common Stock an amount equal to the Original Purchase Price plus any accrued, or declared, but unpaid dividends (the "Liquidation Preference"). After the payment of the Liquidation Preference to the holders of the Series [A] Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series [A] Preferred on a common equivalent basis. A merger, acquisition, or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation.

Company Favorable

In the event of any liquidation or winding up of the Company, the holders of the Series [A] Preferred shall be entitled to receive in preference to the holders of the Common Stock an amount equal to the Original Purchase Price (the "Liquidation Preference"). After the payment of the Liquidation Preference to the holders of the Series [A] Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock. A merger, acquisition, or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation.

CONVERSION RIGHT

Conversion may take place at the option of the holder of the convertible security, upon the occurrence of a specified event, or upon a vote of shares of the class of stock having the conversion right

Conversion rate is the number of shares of common stock into which one share of preferred stock is convertible

CONVERSION PROVISIONS

Investor Favorable

The Seres [A] preferred shall be automatically converted into Common Stock, at the then applicable conversion price, (i) in the event that the holders of at least two thirds of the outstanding Series [A] Preferred consent to such conversion or (ii) upon the closing of a firmly underwritten public offering of shares of Common Stock of the Company at a per share price not less than [3 times the Original Purchase Price] per share and for a total offering with net proceeds to the Company of not less than $40 million (a "Qualified IPO").

Middle of the Road

The Series [A] Preferred shall be automatically converted into Common Stock, at the then applicable conversion price, (i) in the event that the holders of at least two third of the outstanding Series [A] Preferred consent to such conversion or (ii) upon the closing of a firmly underwritten public offering of shares of Common Stock of the Company at a per share price not less than [2 times the Original Purchase Price] per share and for a total offering with gross proceeds to the Company of not less than $25 million (a "Qualified IPO").

Company Favorable

The Series [A] Preferred shall be automatically converted into Common Stock, at the then applicable conversion price, (i) in the event that the holders of at least majority of the outstanding Series [A] Preferred consent to such conversion or (ii) upon the closing of a firmly underwritten public offering of shares of Common Stock of the Company at a per share price not less than two times the Original Purchase Price (as adjusted for stock splits and the like) and for a total offering of not less than $5 million, before deduction of underwriters commissions and expenses (a "Qualified IPO").

ANTI-DILUTION PROTECTION

- Dilution is the effect of an increase in the number of shares of stock a company has outstanding
- Dilution to economic value is the adverse result that follows when the company sells new shares at a price lower than the price that was paid by the existing preferred stockholders
- Down-round financing is an investment in which the pre-money valuation by the new investors is lower than the post-money valuation at the completion of the prior round of financing

ANTI-DILUTION PROVISIONS

Investor Favorable

The conversion price of the Series [A] Preferred will be subject to a full ratchet adjustment in the event that the Company issues additional equity securities (other than the reserved employee shares described under “Employee Pool”) at the purchase price less than the applicable conversion price. The conversion price will also be subject to proportional adjustment for stock splits, stock dividends, recapitalizations, and the like.

Middle of the Road

The conversion price of the Series [A] Preferred will be then subject to a weighted average adjustment (based on all outstanding shares of Preferred and Common Stock) to reduce dilution in the event that the Company issues additional equity securities (other than the reserved employee shares described under “Employee Pool”) at a purchase price less than the applicable conversion price. The conversion price will also be subject to proportional adjustment for stock splits, stock dividends, recapitalizations, and the like. This anti-dilution protection is subject to a play-or-lose provision that provides that adjustments will be made to the Series [A] Conversion Price only if the Series [A] holder participates in such dilutive offering to the extent of its pro rata equity in the Preferred. Any investor who does not participate in a future financing forfeits the benefits of dilution protection [for all future rounds of financing/only for that financing round].

Company Favorable

The conversion price of the Series [A] Preferred will be submit to proportional adjustment for stock splits, stock dividends, recapitalizations, and the like.

REDEMPTION RIGHTS

MAY BE ISSUED TO VENTURE CAPITAL PREFERRED STOCK

FALLS WITHIN A COMPANY'S CATEGORY OF DISTRIBUTION TO SHAREHOLDERS

A BALANCE SHEET CAN PROHIBIT DISTRIBUTION

SURPLUS INCLUDES THE AMOUNT OF NET ASSETS THE CORPORATION HAS IN EXCESS OF ITS CAPITAL

REDEMPTION RIGHTS PROVISIONS

Investor Favorable	Middle of the Road	Company Favorable
At the election of the holders of at least [a majority] of the Series [A] Preferred, the Company shall redeem 1/3 of the outstanding Series [A] Preferred on the [third] anniversary of the Closing, 1/2 of the outstanding Series [A] Preferred on the fifth anniversary of the Closing and all of the remaining outstanding Series [A] Preferred on the sixth anniversary of the Closing. Such redemptions shall be at a purchase price equal to [three] times the Original Purchase Price plus accrued and unpaid dividends.	At the election of the holders of at least [two thirds] of the Series [A] preferred, the Company shall redeem the outstanding Series [A] preferred in three equal annual installments beginning of the [fifth] anniversary of the Closing. Such redemptions shall be at a purchase price equal to the Original Purchase Price plus declared and unpaid dividends.	None.

VOTING RIGHTS

- A class may be given full, limited, or no voting rights
- Preferred stock almost has broad voting rights and typically a special set of rights
- Preferred stock votes with the common stock on an as-converted basis on anything that may be presented to the stockholders for their approval
- Common stock has a general right to vote

VOTING RIGHTS PROVISIONS

Investor Favorable	Middle of the Road	Company Favorable
The Series [A] Preferred will vote together with the Common Stock and not as a separate class except as specifically provided herein or as otherwise required by law. Each share of Series [A] Preferred shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such share of Series [A] Preferred.	Generally the same as Investor Favorable.	Generally the same as Investor Favorable.

LETTERS OF INTENT

- Also known as “memorandum of understanding” or “term sheet”
- It is not binding on any party except parts that explicitly are noted as binding, but never is the entire letter binding
- It is a contract that precedes and enhances negotiation
- It is crucial to disclaim contractual effect

LETTER OF INTENT BROKEN UP INTO FOUR CLASSES

- A group comprised of letters that are used solely to list contractual effect and businesses terms
- A group comprised of letters that are used to lay out the ground rules
- A group comprised of letters identify significant business terms
- A group comprised of letters of intent that have failed

LETTERS OF INTENT CONT.

Exclusivity: the owner does not actively market, privately solicit, encourage inquiry, respond to proposals, discuss proposals, analyze proposals, retain proposals, or even receive proposals

- An owner can prohibit a prospect from responding to a purchase agreement and instead have the prospect pass along the information to prevent a flip

Standards: the ground rules for negotiation determine the standards for negotiation

- Good faith
- Best efforts

Consummation: generally, have agreements as to terms, but no contractual agreement binding the terms. It is in danger of being recharacterized as binding, because of the way way courts have determined cases.

Confidentiality and Access: owners must govern the use of information and who has access to it

Ambiguity and Duplicity: used to create the semblance of an agreement, but differing interpretations of ambiguity lead to court involvement

VENTURE CAPITAL INVESTMENT DOCUMENTS

Preferred Stock Purchase Agreement

- Acts as the controlling document that manages all the elements of a transaction

Amended and Restated Charter

- Sets forth the rights, preferences, and privileges that make up the terms of the preferred stock the venture capital investors will purchase

Investors Rights Agreement

- A collection of covenants provided by the company to the preferred stock investors

Right of First Refusal and Co-Sale Agreement

- Sets forth agreements by the major common stockholders for the benefit of the preferred stock investors and the company

Voting Agreement

- A statutorily authorized mechanism to bind shareholder votes

DUE DILIGENCE

- ❖ Investor's obligation to adequately inform itself regarding securities issuer and transaction
- ❖ Investors focus their legal resources on reviewing documents and representation that may be overly comprehensive
- ❖ Two costly categories to focus on
  - ❖ Ownership interests
  - ❖ The company's ownership of its intellectual property or other agreements that may affect the company's ability to pursue its business
- ❖ Any IP issues that the company discloses must be carefully examined

CLOSING CHECKLIST

- A helpful process management tool and precedent file of deal checklists
  - Compliance certificate
  - Legal opinions
  - Good standing certificates
  - Corporate approvals
  - Right of first refusal documents
  - Management rights letter
  - Stock certificates
  - Securities filings
  - Closing binders

THANK YOU
QUESTIONS?

APPENDIX

PRE VS. POST-MONEY VALUATION

Pre-money or post-money valuation?

- *Post-money valuation = Pre-money valuation + Venture Capital Investment*
- Alternatively, *Pre-money valuation = Post-money valuation – Venture Capital Investment*

Rationale

- Post-money → valuation must be conditional on the financing event because the company is completely transformed by the financing
- Pre-money → the company is made up of pre-financing assets (mainly human capital) and this is independent of the new investment

Ultimately, the truth is somewhere in between, but post-money valuation is more conservative

PRE VS. POST-MONEY VALUATION EXAMPLE

A simplified example

Using pre-money valuation

- ABC Inc., a VR/AR startup, requires $2MM investment to commercialise its new headset patent. It has no other assets
- VC A provides $2MM at a pre-money valuation of $6MM for the patent
- VC A's percentage ownership is 25%. The entrepreneur raises 75%. The post-money valuation is $8MM
- A few months later, *without any further improvements or changes in the company's operation*, ABC realizes that it needs $2MM more and decides to raise another funding round
- ABC will argue that the pre-money valuation in this round is now $8MM (patent + cash infusion)
- But nothing has changed between the two rounds, and as both VC A and VC B provide $2 million, they should get the same ownership of the company

Using post-money valuation

- The VCs can use post-money valuation to compute the present value of all the expected cash flows from the future commercialization of the patent, e.g. $10MM
- VC A providing $2MM will get a 20% stake
- If the 2nd round is required and nothing has changed, VC B providing $2MM should also get 20%