THE VENTURE CAPITAL FUNDING PROCESS AND DOCUMENTATION

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Every company must fund its working capital needs until it becomes self-sufficient. Even then, companies that can sustain themselves often require outside financing to take advantage of temporary market opportunities by developing new products and opening new distribution channels more quickly. It is the rare company that can fund its needs internally, and mature without concern of competitive pressures. Companies that are able to operate without outside sources of capital typically choose this path so as (a) not to give up management control and equity share to the investors, (b) control the rate of growth of the company, (c) focus on goals other than making money (though pursuing personal goals and making money are not necessarily mutually exclusive), and (d) delay or avoid altogether a liquidity event such as an IPO, merger or acquisition. Further, the companies that can fund operations internally typically have low capital requirements - and fully established services or product lines within a short period of formation.

Most companies, however, must fund operations in private financings until they mature. Angel financings can and often times do have many or all of the characteristics of venture capital financings, and therefore understanding venture capital motivations and tendencies is critical to effective angel financings. This paper will review the process and issues that arise in venture capital financings (referred to below as a "Financing") - typically for technology-based emerging growth companies. Many of the principles here will also apply to private financings in non-technology companies by investor groups that do not include venture firms.

One: Preliminary Considerations and The Financing Process

Before the Company and investors negotiate any of the terms of the Financing, the Company must consider what securities are being offered to the investors, how much the Company intends to raise and what equity ownership to give to the investors. Further, management should understand the financing process, and what documents will be negotiated and executed on the closing of the Financing.

1. Securities Offered. In most cases, management will want to offer Preferred Stock to the investors. Common Stock should be avoided for several reasons. The amount raised in the Financing spread over the number of shares of Common Stock offered will, typically, cause the price/share to increase dramatically. This high stock price may create a risk that lower-priced shares offered to the Company's founders within a relatively short period of the Financing will be deemed by the IRS to be "discounted" shares that are taxed at ordinary rates on the spread between the discounted price and the purchase price in the Financing. The high price will also set the price/share for future issuances to employees as incentive compensation. The concern here is that the high price may discourage rather than incentivize employees. Equally important is the dilutive effect on the founders. If the Company's Board does not wish to increase the price of the Common Stock the reasons described above, then the founders' equity in the Company will be diluted significantly.

With the issuance of Preferred Stock, all of these problems can be avoided. The Preferred Stock is priced higher than the Common based on the value of the preferential rights, resulting in lower dilution of the founders. Further, the price of the Common is largely unaffected by the price of the Preferred (though the Common Stock price is typically raised to 10-20% of the price of the Preferred after a Series A Financing, and gradually increased as a percentage of the Preferred price with each subsequent Financing) - thereby preserving the advantages of having a low price for the Common Stock. Investors welcome the issuance of Preferred Stock in early-stage companies inasmuch as this stock is fully convertible into Common Stock, but until conversion this class enjoys special rights, typically including (a) dividend and liquidation preferences, (b) antidilution protection, and (c) protective rights (requiring a special class vote of the Preferred Stock in the event of certain corporate events - such as the sale of assets, merger or reorganization of the Company, or the assumption of corporate obligations in excess of certain amounts.

In some cases where the investors seek greater security given the risk they perceive in the Company, management might consider the issuance of convertible, secured debt instruments. These securities provide the investor with interest, place the investor as a secured creditor above all equity holders in the event of insolvency, and enable the investor to convert to equity securities in the Company at the investor's election. While the issuance of debt securities obligates the Company to repay principal and interest until the instrument is converted - it may be the only means of causing investors to commit to fund the Company if the risk is too high.

2. Technology Valuation and Equity Ownership. As described in our paper entitled "The Valuation of Newly-Formed Technology Companies", private companies are almost always valued on the present value of future cash flows during a growth/maturity period of from 3 to 5 years. Venture investors typically apply one of several forms of discounted cash flow analysis to formulate a range of acceptable company valuations. These valuations rest on investor assumptions on product introduction, market growth, earnings and capital market multipliers that will applied to earnings. Management should have its own analysis of these factors, and discuss these considerations with the investors in order that both sides may feel comfortable with the value that has been established. Once company value is set, the investors' equity participation is easily determined as the ratio of the aggregate investment to the accepted value of the Company.

Note that the establishment of valuation is negotiated - and the analysis generally described above is only a tool that helps in setting this amount. The leverage management and the investors bring into the process also has much to do with valuation. Obviously, the more promising the Company is, the more concessions the investors should be willing to make on price (within certain parameters that venture capital partnerships must follow under their partnership agreements).

3. The Private Financing Process. Listed sequentially below are the steps normally followed in venture-backed financings:

• Step 1: The Company's advisors (lawyers, accountants, consultants) introduce the Company to venture capital firms - or management under takes this task directly.

• Step 2: Management presents the Company to the investors. This involves a review of the business plan, product demonstration, validation of the markets, and some initial due-diligence investigation by the investors.

• Step 3: Interested investors explore with management the Company's value, value is agreed on, the aggregate purchase price is agreed on and investor equity participation is agreed on.

• Step 4: Legal counsel for the Company and the investors agree on a Term Sheet setting forth the business terms of the investment. Typically the Company agrees to a "lock-up" for a defined period, under which it agrees not to discuss its funding needs with any other investment group. On acceptance and execution of the Term Sheet, the parties each agree to negotiate the final terms of the Financing as found in certain definitive agreements listed below.

• Step 5: Legal counsel for the Company drafts transaction documents, which are reviewed by investor counsel. Negotiations between the parties are conducted through their respective legal counsel until all legal and business issues are addressed. Throughout this period, the investors are conducting their more detailed due diligence investigation of the Company - such as reviewing the Company's books and records, talking to customers, employees and suppliers, and reviewing and verifying financial statements and projections of performance.

• Step 6: The Closing of the Financing may take place immediately on execution of the definitive agreements, or after 2-4 weeks period following the execution of these agreements. This depends on whether (a) the investors require additional time to complete their own due-diligence (separate from reliance on representations made by the Company to the investors in the transaction documents), and (b) the financial needs of the Company. For example, the Company may not have sufficient reserves to continue operations during the period between the execution of documents and the subsequent closing date.

4. Documentation. The principle documents normally executed between the parties, or filed with the Secretary of State, include the following:

a. Articles of Incorporation. The Articles of Incorporation, or "Amended and Restated Articles of Incorporation" (as is typically the case if Articles of the Company are already on file with the Secretary of State), set forth the rights, preferences and privileges of the class of securities being offered to the investors. The Articles must be approved by a majority of the Board, and a majority of the shareholders (except in the case of "Blank Check Preferred Stock" described below). Supermajority shareholder approval of the Articles, or approval of separate classes of securities may also be required if so provided in the existing Articles of the Company.

b. Preferred Stock Purchase Agreement ("SPA"). The SPA serves several purposes. Basically, it sets forth the terms under which the investment will be made (not including the terms of the stock, which are described in the Articles). The SPA also acts as a disclosure document, it sets out the conditions precedent to the sale of the securities, and it describes the affirmative and negative covenants of the Company with respect to future operations.

c. Investor Rights Agreement ("IRA"). The IRA typically provides the investors with certain contractual rights not described in the Articles or the SPA. These rights may include (i) certain rights to receive regular financial information and reports from the Company, (ii) a right to have the securities issued in the Financing publicly registered with the SEC, (iii) a right of first refusal on the purchase of securities in future financings, and (iv) certain "co-sale" rights that enable the investors to co-participate in stock sales made by the founders or employees. Often times the “co-sale” rights are contained in a separate agreement.

Two. Issues in the Articles of Incorporation

The primary issues in the Articles concern the rights of the securities to be issued in the Financing, including the following:

1. Creation of the Securities. The securities are created when the Articles are properly approved and accepted with the Secretary of State for filing. As mentioned, normally the draft Articles are presented to the Board and the shareholders for approval. In some cases, the shareholders may have pre-authorized the issuance of Preferred Stock, called "Blank Check Preferred", which permits the Board to set out the rights of future classes of Preferred Stock without shareholder approval. Even in the case of Blank Check Preferred, shareholder approval might nonetheless be required under applicable corporate law if (a) the number of shares of Common or Preferred Stock authorized for issuance is increased, or (b) the new class of

securities will change the rights of any other existing class of securities.

2. Liquidation Preference. The principle attribute of Preferred Stock is the right the holder has to a priority payout of liquidation proceeds on the insolvency and liquidation of the Company. This payout is made from proceeds on sale of the Company's assets, with first payment made to secured and unsecured creditors - and payment then made to the Preferred shareholders and then the Common shareholders. Negotiation focuses on the following points:

a. The Amount of the Payout. The payout consists of the original purchase price of the securities, and may also include (i) adjustments for stock dividends, combinations or splits and (ii) accrued but unpaid dividends.

b. Participating Preferred. In recent years venture investors have insisted on return of their liquidation, and then participation in the distribution of remaining proceeds to the holders of Common Stock (known as "Participating Preferred"). Further negotiation will focus on whether the Common Stock first receives back its own purchase price before the Preferred Stock participates in the remaining proceeds, or if the Preferred participates in all proceeds before the Common gets back its purchase price. The most attractive companies may limit investors to their preference return only, while companies struggling for funding may have to agree to a participating return.

c. Payment of Preference on Merger, Consolidation or Sale of Assets. Venture investors also usually require the Company, at the investor's election, to pay the liquidation preference on a merger, consolidation or sales of the Company's assets. This enables the investor to recoup its investment in transactions where the proceeds would not be sufficient for this purpose.

3. Dividend Rights. Preferred investors also usually require that the Company first pay dividends to the investors before making dividend payments on the Common Stock. While emerging-growth companies do not usually pay dividends - investors insist on preferential dividends in order to encourage the use of retained earnings for working capital purposes. The outcome of the following points is usually determined, again, by the attractiveness of the Company:

a. Dividend Amount. The Articles may provide for prior payment of dividends in whatever amount is declared by the Board, or for prior payment of a fixed dollar amount - usually between 5%-10% of the original stock purchase price - before dividend payments are made to the Common Stock.

b. Cumulative Dividends. With less attractive companies, the investors may insist that dividends accumulate from year-to-year, and that all cumulative dividends must first be paid to the investors before the Common. Mandatory cumulative dividends are also sometimes required by the investors - which require the Company to accumulate and make periodic dividend payments to the Preferred, subject to corporate law prohibitions on making dividend payments if the Company cannot meet certain financial tests. Mandatory dividends are quite burdensome on the Company, and are only appropriate where the investment carries considerable risk, and probability of liquidity in the form of an IPO or merger/acquisition is quite low.

4. Redemption Rights. Redemption entitles either the Company to "call" the stock for repurchase, or the investor to "put" the stock to the Company to get liquidity. Optional redemption by the Company is extremely rare - and usually limited to very attractive companies that can demand the right as a condition to the Financing. Companies might seek optional redemption as means of simplifying the Company's capital structure and forcing a conversion to Common Stock (thereby avoiding the preferences of the Preferred Stock).

More typically, the investors will insist that the Company redeem the investors' stock, at the investors' election and under certain conditions. In this event, the parties must agree on the following:

a. The Redemption Price. The redemption price usually consists of (i) the original purchase price, (ii) accrued and unpaid dividends and (iii) a redemption premium. The investors may want to limit the redemption premium in order to avoid a "constructive dividend" tax being assessed on the premium under Section 305 of the Internal Revenue Code. Under Section 305, the entire amount of the premium will be taxed at ordinary rates if the IRS determines that the premium is unreasonable. The tax is payable on an economic accrual basis which imputes greater constructive dividends in later years. A safe-harbor under the applicable regulations provides that a premium of no greater than 10% over 5 years is reasonable. Many venture investors seek premiums in excess of the safe-harbor under the view that the inherent risk of early-stage investment justifies the premium. Nonetheless, management should raise the tax implications under Section 305 in order to minimize the payment of premiums.

b. Mandatory vs. Optional Investor Redemption. Mandatory redemption typically is not attractive to either the company or to investors. For investors, mandatory redemption discourages new investors from participating in future financings given the risk that working capital will be used to redeem earlier investors. For the Company, the redemption makes it difficult for the Company to obtain bank loans and trade credit. Option redemption at least provides both parties with greater flexibility to address future capital needs.

5. Conversion Rights. Venture investors almost always insist on the issuance of Preferred Stock that is convertible into shares of Common Stock. Inasmuch as companies typically only register their Common Stock in IPOs, con-

version permits the investor to participate in the IPO or any other liquidity event (such as a merger or acquisition) involving the exchange of Common Stock. The conversion rate of Preferred into Common Stock is calculated by dividing the original purchase price by a "Conversion Price" which is initially set at the purchase price (for a 1-to-1 conversion of Preferred into Common Stock). The Conversion Price is adjusted to provide investors with antidilution protection under certain events as described below.

Issues relating to the conversion of Preferred Stock include the following:

a. Voluntary and Automatic Conversion. The Company should have no problems with an investor's election to convert into Common Stock. This removes the preferences otherwise provided to that shareholders. In addition, it is mutually advantageous, to the Company and the investor, to provide for automatic conversion on an IPO. With conversion, the Company is able to simplify its capital structure (a pre-requisite to the public offering), and the investor is able to participate in the offering. Debate focuses on the size of the contemplated IPO - which the parties try to set at a size sufficient to create an adequate "float" for the public stock. Though unusual, the investors might also insist on payment of accrued but unpaid dividends - either in cash or stock. Most typically, accrued dividends are waived.

b. Mechanical Antidilution Protection. In the event of a stock split or reverse split, or distribution of a stock dividend, the Articles almost always provide for downwards adjustment of the Conversion Price - such that the Preferred Stock will convert into that number of shares of the Common Stock that will maintain the investor's equity participation in the Company.

c. Price-Based Antidilution Protection. Unlike mechanical antidilution protection, the application of price-based antidilution protection is much more open to question. This type of protection adjusts the Conversion Price downwards, under an agreed-on mathematical formula, for an issuance of new securities at an effective price below the then-current Conversion Price. Price-based antidilution protection is always required by venture investors - though less sophisticated investors, or investors friendly to the Company, may not insist on it (thereby giving management greater flexibility in bringing in new money into the Company at lower effective per-unit prices - which may be necessary with a downturn in the Company's prospects).

Debate here focuses on whether "Weighted Average" or "Ratchet" price-based antidilution protection is to apply. The Weighted Average formula considers the discount price of the new securities, and the number of securities sold, in adjusting the Conversion Price downwards. Under this type of formula, the sale of a large number of securities at a price slightly lower than the Conversion Price, and the sale of a small number of securities at a much lower price will both result in a relatively small adjustment of the Conversion Price. Weighted Average antidilution favors the founders by minimizing the dilution of their stock on the future issuance of discount stock. The following is the mathematical formula applied in this approach:

Weighted Average Antidilution Formula

New Conversion Price	=	Old Conv. Price	X	Fully Diluted Shares Before New Issue	+	No. Shares @ New Money at Old Conv. Price

The Ratchet formula automatically decreases the Conversion Price to the price at which the new discounted issuance is made - irrespective of the number of new shares issued. This, obviously, has a far greater dilutive effect on the founders. Hybrids of both the Weighted Average and the Ratchet formulas sometimes include (a) initial application of the Ratchet formula for 2 years, followed by the Weighted Average formula (to discourage the early discounting of stock), and (b) application of the Ratchet formula only for an issuance beneath a certain threshold price.

d. Carve-out for Incentive Stock Issuances. Typically, a pool of shares ranging in size from 10-20% of the outstanding fully-diluted stock of the Company, is set aside for issuance to key employees. This pool is not subject to the price-based antidilution provisions. The size of this pool is a negotiated term of the Financing -and the pool is adjusted from time to time to accommodate future issuances - subject to a veto right held by the investors.

e. "Pay-to-Play" Provisions. Investors have often insisted on negotiating "pay-to-play" provisions into antidilution provisions. Under these provisions, only those investors who make pro rata investments in future financings receive antidilution protection. These provisions encourage future investment, and for that reason should not be resisted by management. Investors that are not committed to the Company will try to resist pay-to-play provisions, while investors that expect the Company to mature and go public will support such provisions. Pay-to-play provisions are expressed in one of three ways: (i) forced conversion of non-participating investors into Common Stock, (ii) forced conversion of the Preferred Stock into a parallel series of Preferred Stock with no price-based antidilution protection, or (iii) a contractual waiver of any antidilution adjustments for non-participating shareholders.

6. Voting Rights. Each share of Preferred Stock is usually entitled to that number of shareholder votes equal to the number of shares of Common Stock into which the Preferred converts. Notwithstanding the general rule of 1 vote per share, the following variations to voting rights are

heavily negotiated:

a. Board Seats. It is often a condition to investment by venture capitalists that the series of stock that they purchase be entitled to elect 1 or 2 members to the Company's Board. More unusual are "voting shift" provisions under which the Preferred shareholders may elect additional directors, or a majority of the Board, in the event of poor performance by the Company.

b. Protective Rights. In addition, venture investors also seek a separate class vote (requiring a majority vote of that class or series of stock purchased by the investors in the Financing) for such corporate events as a merger or acquisition of the Company, changing the Company's primary business, entering into license agreements other than in the ordinary course of business, the payment of dividends, the redemption of stock, the borrowing of money above certain amounts - and other similar material corporate events. The Company will want to resist or restrict the application of the separate class vote in order to preserve its ability to manage the Company's affairs without this shareholder oversight. One means of diffusing or canceling the long-term effect of such provisions is to provide in the Articles that the protective right goes away once the number of original purchasers of the class of securities sold in the Financing is reduced below a certain percentage. For example, the Articles might provide that once less than 25% of the shares are held by the original purchasers, then the separate class vote goes away.

Three: Issues in the Preferred Stock Purchase Agreement
The securities sold in the Financing are also subject to the covenants made by the Company and the investors to each other as described in the SPA.

a. Company Representations. The investors will require the Company to make representations concerning (i) its good standing, (ii) approval of the Financing, (iii) its capital structure, (iv) the ownership of its technology and other assets, (v) full disclosure to the investors of all material information they need to make an informed investment decision, (vi) the accuracy of the Company's financial statements, and (vii) the absence of litigation or known or probable claims against the Company.

b. Investor Representations. The Company will require the investors to make certain representations concerning (i) their qualification to purchase the securities under applicable securities laws, (ii) proper approval of the investment, and (iii) an acknowledgment made to the Company that the investor has had access to Company information, and had the opportunity to ask all questions material to the investor to make an informed decision.

c. Company Counsel Opinion Letter. To support legal representations made by the Company concerning (i) its capital structure, (ii) issuance of the securities in conformance with applicable securities laws, and (iii) proper corporate approval of the Financing - the investors will usually require the Company's legal counsel to deliver an opinion letter to the investors at closing on these points. This document is also heavily negotiated between Company and investor counsel - as this opinion exposes Company counsel to liability for untrue opinions, as well as the Company.
Four: Issues in the Investor Rights Agreement

In addition to the rights afforded the investors as described in the Amended and Restated Articles, and in the SPA, the investors usually also insist on additional contractual rights typically described in an "Investor Rights Agreement". The investor rights described in the IRA are placed into a separate agreement in order to make it easier to amend the agreement to add subsequent investors on a "pari pasu" basis - or equal in rights to all other investors who are party to the agreement. For this reason, rights that are specific to a given class of shareholders are set forth in the Articles or the SPA.

The rights typically negotiated into the IRA by investors include the following:

1. Information Rights. Notwithstanding that the investors will probably have a representative on the Company's Board, each of the investors will also require financial information and reports from the Company. Specifically, the investors will try to require the Company to provide annual financial statements within 60-90 days of the end of each fiscal year, and interim financials within 30 days of the end of each quarter. In addition, the investors will request a report from management of material developments with the quarterly financial statements. The Company should not resist the delivery of this information, provided (a) sensitive competitive information is not disclosed, and (b) unaudited financials are sufficient. The Company may be required to provide audited annual financial statements as the Company matures - which is in the Company's interests inasmuch as 3 years of audited financials must be presented to the SEC with the Company's S-1 Registration Statement filed on its initial public offering.

2. Registration Rights. To compel the Company to publicly register its stock and include the investors' stock in the registration, the investors will negotiate into the IRA "demand", "piggy-back" and "S-3" registration rights as follows:

i. "Demand Registration Rights" entitle the investors to demand that the Company register its stock after 3 to 5 years from the seed investment in the Company. Exercise of the demand does not necessarily mean that it will happen. Management can usually resist the demand if, in its discretion, business conditions are not favorable.
While the provision usually provides that management can only delay the demand once, practically the registration cannot be made without management's full cooperation

and support. All expenses incurred in demand registrations are normally paid by the Company.

ii. "Piggy-Back Registration Rights" obligate the Company to use its best efforts to include the investor stock in public registrations it intends to make. This right is subject the underwriter's right not to include the investors' stock in the offering - and the right may not be made in connection with the offering of securities in the context of a corporate acquisition or employee stock benefit plan.

iii. "S-3 Registration Rights" entitle the investors to register their securities in Form S-3 registrations, which are available to the Company if it makes periodic filings with the SEC under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934. These filings can incorporate by reference information that has been previously filed with the SEC, thereby dramatically reducing the cost of the registration. The Company will often require the investors to pay for their own costs incurred in this type of registration.

3. Rights of First Refusal. Investors will also try to negotiate into the IRA a right of first refusal on the purchase of securities offered by the Company in the future which enables the investor to maintain its equity interest in the Company. This right entitles the investor to receive notice of the offering, and to purchase its pro-rata share of the securities being offered under the same terms offered to new third-party investors. The right may also entitle the investor to purchase securities not purchased by other investors under their right. The Company should have no difficulty in making this right available to the investors, provided that the investment terms are the same offered to other investors. The right does not apply to stock issuances to employees as incentive compensation, to issuances made in connection with a merger, acquisition or reorganization - or issuances made to the Company's commercial lenders and equipment lessors in the ordinary course of business.

4. Co-Sale Rights. Finally, as a means of achieving liquidity and preventing the founders from "bailing out" of the Company before the investors, the investors may require the founders to provide the investors with a right of co-sale on the founders' stock. Under a right of co-sale, founders give the investors the right to participate pro-rata in any sale of the founders' shares to a third party. The number of shares that the founders can sell is reduced and replaced by the number of shares that the investors elect to sell to the third party.

The resolution of the issues described in this paper depends almost entirely on the attractiveness of the Company to the investment community. Concessions on the terms of investment will not cause the investment to be made if the Company is not sound - as evidenced by its business plans, its identification and approach to the market - and other factors considered in the valuation of the Company. Once the Company has generated serious investor interest, then these issues become important. Dilution, voting rights and Company covenants such be the main focus of both the Company and investors in these negotiations. Ultimately, all parties must be satisfied with the terms of the investment in order to avoid future misunderstandings.