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RAISING PRIVATE CAPITAL:
A ROAD MAP FOR ENTREPRENEURS

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Start up, development stage, and “expansion stage” companies often need external financing and often face difficulties in obtaining capital. Banks, insurance companies, and other sources of debt and equity capital generally may not make loans or equity investments in these companies, and in almost all cases, the public capital markets are closed to these companies. Nonetheless, these companies can, and in many cases do, obtain capital from sources such as personal funds or credit of the founders and management (including personal credit cards), their relatives, and friends, wealthy individuals with a penchant for investing in development and early stage enterprises, and venture capital funds.

1. Show me the Money! – Sources of Capital

1.1 Angels. Angels are wealthy businessmen who often are also experienced entrepreneurs who have been through the cycle of starting, growing, and selling a company. Angels can provide experience and valuable introductions to other investors and businesses. There have been attempts in Georgia to organize a “market” to assist small businesses and angels in meeting each other. The most prominent of these groups in Atlanta are the Atlanta Technology Angels, Band of Angels, and the Communications Group. Meetings of these groups are by invitation only. Invitations are secured, if at all, after a review of a business plan and an interview. Not all angels are affiliated with a group, so ‘traditional” means of referrals and introductions from accounting and law firms are still important. Other ways to meet angels are from the founders of other startup businesses, and attendance at professional and civic organizations organized to foster small business development, capital formation, or enterprise development.

1.2 Incubators. Incubators are organizations funded by private individuals, companies, or academic institutions. Typically an incubator provides office/warehouse/manufacturing space, support services, and small amounts of capital to early stage companies. Incubators in the Atlanta area include ATDC (Georgia Tech’s Atlanta Technology Development Center) and Intelligent Systems Corporation.

1.3 Venture Capital Funds. Venture capital funds are the primary sources of expansion, and in some cases, development/early stage capital. Venture capital funds typically focus their investing activities in particular industries, geographies, and/or a stages of development. Venture funds turn down far more deals than they fund. Many (some would say most) venture capital funds have limited interest in “start-up” businesses, unless the fund has a prior (successful) relationship with the senior management of the start-up. While every fund is a little different - the initial analysis of a potential investment by a venture fund typically consists of several criteria:

- Does the company have a proprietary technology, proven product, or a well executed service – that solves a real (vs. imagined) industry or technological problem?
- Is the addressable market large (in excess of $100,000,000) and growing (at least 15% per year)?
- Does the company have, or is it likely to have, a dominant position in its market? Is there a sustainable competitive advantage?
- Does the company have a capable, tested senior management team? Have members of management successfully engaged in another entrepreneurial business endeavor?
- Is the company valued fairly?

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Venture capital funds often provide value to a company in addition to capital. Venture capital firms may provide mentoring for management, introductions to potential clients, strategic partners, and vendors, access to investment bankers, accountants, and lawyers, assistance in recruiting, and other services that are frequently needed by a growing company. The price company owners pay for an association with a venture capital firm is a dilution, a significant reduction in management autonomy through mechanisms venture capitalists use to monitor and control their investments, and a significant amount of time and attention to prepare for board meetings and to comply with the information requests of venture capitalists.

1.4 Strategic Partners. For some companies a strategic partner may be an appropriate alternative to a venture capital fund. A strategic partner typically will be a corporation in the same or a related industry as the company. A strategic partner may provide access to markets, credibility for the product or service, capital, technical or other resources, and advice and support for management. The most significant disadvantages of the strategic partner approach are: the possibility that the company will become an outsourced development arm of the partner, may have to give up substantial rights in the technology developed by the company, and/or may be acquired by the strategic partner prior to realization of its full market potential. Strategic partnering is an underused, but valuable means of obtaining growth capital.

2. Brother Can You Spare a Dime: - How to find an Investor

One of the first action items most companies should address before attempting to raise private capital is a candid self evaluation. Is the company in a position to have a realistic probability of locating investors and closing a financing? The company should carefully review the contacts of the principals and founders together with the contacts of their lawyers and accountants. In many cases, the answer to such a candid self examination will be no. In such cases, the company may consider a number of alternatives to getting in front of investors.

2.1 Networking. The traditional method of contacting potential investors is networking and cold calls.

2.2 Placement Agents. Placement agents are "brokers" and "finders." They range from large and prestigious investment banks to small boutique investment banking firms to loan brokers to stockbrokers. Occasionally, one can locate them through an advertisement in general or specialized newspapers, or on the Internet, at sites such as Internet Capital Exchange and International Financial Consultants, Ltd., or other on-line networks. If the company determines that it needs to engage a finder or broker, it should obtain recommendations from its advisors and friends and then interview as many candidates as necessary until the company reaches a comfort level that it understands the process and has gained confidence in one or more of the candidates. This is a *very* important decision for the company.

Placement agents may not be able to complete all financing engagements they accept on terms which are acceptable to the company. This will cost the company time and money and may "poison" the image of the company in the private capital market. Fees charged by placement agents will be in the range of 5%-10% of the capital raised plus expenses incurred. Placement agents generally require a non-refundable retainer of $25,000-$50,000 and may request options or warrants and rights of first refusal on subsequent financing, including any initial public offering. In all cases the company will be expected to indemnify the placement agent.

Recent changes in federal law have substantially increased the risk to a company using a finder that is not registered as a broker dealer. You should seek legal counsel before entering into a written agreement with any placement agent or unregistered broker dealer.

2.3 Public Solicitation of Accredited Investors. In early July 2012, one of the key legal impediments to raising capital in private offerings may disappear. Prior to the Jumpstart Our Business Startups Act (the "JOBS Act"), signed into law by President Obama on April 5, 2012, general advertising and/or public solicitation was not permitted in "private" capital raising activities[1]. Essentially this required a "pre-existing relationship" between the company and persons approached for investment. The relationship could be with the company or with a person acting on behalf of the company, such as a lawyer, accountant, financial adviser (investment bank for example), or shareholder. The JOBS Act also eliminates some of the regulatory impediments to the operation of "portals" that would introduce accredited investors to companies seeking to raise capital. Existing law remains in effect until the new regulations are adopted, but help may be on the way.

2.4 Crowdfunding. Crowdfunding is the process of raising small investments from a large number of investors. The JOBS Act requires the SEC to promulgate regulations by the end of the year to exempt certain crowdfunding offerings from the registration provisions of the Securities Act of 1933. A crowdfunding begins with the company selecting a crowdfunding website, such as Kickstarter.com, and establishing a profile. Crowdfunding can be structured as: (1) a donation, (2) a reward for a donation or an early purchase of a product or service, (3) a pre-purchase, and (4) a purchase of an equity stake (under current law there are significant regulatory issues with a public solicitation of a security). Under the donation model, contributors make a donation to support some project without receiving anything tangible in return. Under the reward model, supporters make a monetary contribution in return for a reward of some sort, for example, a filmmaker might give supporters tickets to the premiere. Under the equity model, investors receive an equity interest in the enterprise. Companies should be aware that crowdfunding may significantly limit the interest of 'professional" investors such as venture capital funds because of the large number of presumably unsophisticated shareholders that might result from crowdfunding.

3. Private Placement? Negotiated Transaction? What's the difference?

A second action item to address is whether the company will attempt to raise capital through a private placement or a negotiated transaction. In a private placement, the company is soliciting offers to purchase a security. The company determines the valuation, amount raised, and structure and terms of the proposed financing using a private placement memorandum. Using the private placement memorandum, the company conducts a private offering and attempts to find investors willing to purchase the securities on the terms offered. If the company seeks to raise investment capital from individuals (family and friends), a private placement may be a good choice because such investors may not have the sophistication and skill to vigorously negotiate the terms and conditions of the investment. Accordingly, terms suggested by the company, if realistic in light of the risks, may receive favorable consideration.

In a negotiated transaction, the company circulates a memorandum or business plan to attract one or more interested investors and negotiates the terms and conditions of the investment with a "lead" investor who typically will engage counsel to prepare the investment documents. This is the typical

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[1] Section 5 of the Securities Act of 1933 prohibits the use of the U.S. mail or other means of interstate commerce to effect the offer or sale of any security ***unless*** a registration statement is in effect or an exemption is available.

approach if the company seeks to raise investment capital from venture capital firms, strategic partners, incubators, or organized angel groups (like the Atlanta Technology Angels). The goal in a negotiated transaction is to identify a "lead investor" who assumes responsibility for due diligence and the structuring and negotiating the terms of the investment. After the lead investor is identified, the portion of the capital not furnished by the lead investor is sought from other investors. Of course a private placement may evolve into a negotiated transaction.

A negotiated transaction is consummated through a securities purchase agreement in which the company makes numerous representations and warranties which are intended by the parties to provide much of the detailed disclosure which would be contained in a registration statement. In most cases the business plan or private placement memorandum would be attached to the securities purchase agreement as an exhibit. In addition to a securities purchase agreement, there will be a number of ancillary agreements between the investors, the company and the officers, directors, and shareholders of the company which provide many "controls" which are discussed in more detail in Section 5 of these materials. Generally a negotiated transaction with a venture capital firm will require the company to file an amendment to its corporate charter which creates a series of preferred stock. There will also be various agreements (discussed in more detail below) such as:

- an ***Investors Rights Agreement*** which contains registration rights and may contain other covenants regarding the ongoing obligations of the Company due to the investors, such as a contractual right to purchase all or part of certain new issuances of securities.

- a ***Right of First Refusal and Co-sale Agreement*** which obligates the founders and other key management employees to offer any shares they may elect to sell first to the company and then to the investors and to the extent that the company and the investors elect not purchase the shares, obligates the founders and other key management employees to require the purchaser of their shares to purchase an equivalent number of shares from the investors as a condition to completing the sale with the founders and or other key management employees.

- a ***Voting Agreement*** which obligates the founders and other key management employees to vote their shares to maintain a stated board size and elect designated persons to the board of directors.

Model agreements are available from the National Venture Capital Association website.[2]

4. Disclosure: - Information to give to an Investor

4.1 The Business Plan. Regardless of whether the company seek investment capital through its officers and directors or engages a placement agent, the company will prepare a business plan which describes the company, its products, services, and present and proposed business activities, the industry in which it operates, the experience of the company's founders and management, the competitive environment, the uses of the capital raised, current financial statements, and management's projection of future sales and revenue. The business plan will typically be prepared by the company and may be reviewed by its advisors, accountants, and lawyers. A business plan is not a "private placement memorandum," and can omit some of the details required in a private placement memorandum. Prior to any sale of securities, certain additional materials (typically legends, risk factors, plan of distribution, and

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[2] http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136.

description of the securities) must be furnished to investors prior to any purchase of securities (delivery of funds is a factor which suggests a sale has occurred). Federal and state securities laws may require that specific information be provided to investors prior to the sale of any security, thus consultation with an experienced attorney that is well versed in the federal and state securities laws and corporate finance transactions is advisable.

A business plan has certain advantages over a private placement memorandum. First, it will not contain the detailed description of a security, which is useful in negotiations with potential lead investors. Second, it is not viewed as a "boilerplate" document and provides a good vehicle for thorough disclosure through individual meetings with the investors. Third, the most costly elements of securities law compliance are deferred until much of the risk of failure of the proposed financing has been eliminated. The business plan should be 20-30 pages in length and include a one to two page executive summary. The executive summary may be the most important section of a business plan – it's the first and maybe only opportunity to grab a potential investor's interest. Topics to be included in the business plan include:

- ***Company description, location, and history;***
- ***Products or services offered or to be developed;***
- ***Sales and marketing plan;***
- ***Size of the market;***
- ***Competition;***
- ***The company's competitive advantage;***
- ***Management and organization;***
- ***Projected revenues and financial statements;***
- ***Operational plan; and***
- ***Amount and proposed structure of the financing.***

The bulk of the business plan should be devoted to the size of the market, targeted customers and how they will be reached, competition, and competitive advantages. Some of the major accounting firms have detailed materials providing instruction in the preparation of a business plan. Some venture capital firms require the business plan to prepared according to a template they provide. There are several software packages widely available to assist in the preparation of the business plan. There are differences of opinion if business plans prepared

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4.2 The Private Placement Memorandum. The business plan is the starting point in the preparation of a formal private placement memorandum. State and federal law specify the contents of a private placement memorandum. The requirements imposed by law are "minimums," and the company may provide additional information which isn't "required" by statute, rule, or regulation.

5. Structuring the Investment.

5.1 Valuation and the Price Per Share Paid By Investors. Valuation is in the eye of the beholder. Typically a starting point is a discounted cash flow analysis of the Company's projections with appropriate adjustments for execution risk, time to liquidity, minority status, and private company status. Current "pre-money" valuation is "backed into" based upon comparable public company P/E ratios, the number of years to an estimated exit transaction, and the return on investment requirements of the investor. The valuation may also consider the valuation at which prior investment was made, any recent arm's length sale or transfer of the company's stock, the value of tangible and intangible assets of the company, and the replacement cost of technology or other assets. Valuation may also take into account qualitative factors such as the depth and experience of the management team, the stage of development of the product and service, the condition of the market and competition (e.g. whether the company is a "first mover"), the current revenue run-rate and cash flow, and barriers to entry that might impede the entry of competitors into the market.

A subjective observation suggests that a first round venture capital investment will typically result in a 30% - 45% ownership by the investors. Founders are often surprised to learn that the "pre-money" common stock equivalents used to determine the share price that will be paid by the investors includes a reserve of shares for a stock option plan that dilutes the founders (and other existing stockholders) but not the investor. The typical stock option plan reserve will be between 10% and 20% of the "post-money" common stock equivalents. The more positions in the management team that will need to be filled, the larger the reserve. To illustrate the effect of the inclusion of a stock option plan reserve in the pre-money outstanding common stock equivalents, consider the following example:

Pre-money valuation is $6,000,000 and the investors will invest $3,500,000.

Without a stock plan reserve, the existing stockholders would own approximately 63% of the Company[3]. With a 15% stock option plan, the fully diluted ownership of the existing stockholders would be approximately 48%[4]. Assuming there are 3,500,000 shares held by the existing investors, outstanding warrants exercisable for 1,000,000 shares, and the above mentioned 15% stock option plan, the price per share paid by the investors and the pro-forma post investment cap table would be:

	Shares	Percent
Existing Securityholders	4,500,000	48.16%
Stock Option Plan	1,401,639	15.00%
Investors	3,442,623	36.84%
Total	9,344,262	100.00%

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[3] Existing stockholder ownership percentage before stock plan = $1 - \frac{invested\ capital}{pre\text{-}money\ valuation + invested\ captial}$

[4] Existing stockholder ownership percentage after stock plan =

$1 - \Sigma \frac{invested\ capital}{pre\text{-}money\ valuation + invested\ captial}$ and % of "post money" Stock Option Plan reserve

$1.02 per share paid by investors,

There is perhaps no place where one's choice of company counsel will be more important than in the negotiation and structuring of a venture capital investment. Company counsel should have a realistic understanding of the risks involved in a private capital investment from the investor's perspective and an understanding of the motives for private equity investors. There are many risks that private capital investors face including: undetected flaws in the company's business model; lack of managerial skills necessary to execute the business plan; occurrence of unforeseen delays which "push out" the time horizons anticipated for the accomplishment of the objectives of the business plan; incurrence of unforeseen expenses that require additional capital which may not be available, or if available, is available on terms that are substantially dilutive to current investors; founder fatigue in which the founders become "burned out" and must be replaced; and infrequently, fraud. The investor will generally seek to manage these risks through the documents and instruments which create the investment security and memorialize the investment transaction.

Generally, the motive for private equity investing is either (a) financial, *e.g.* to secure substantially above average rates of return, or (b) strategic, *e.g.*, to ensure access to technology or markets. Fundamentally, private capital investors make high risk investments with the expectation that over a defined investment horizon, the capital invested will be returned together with a substantial return on investment.

The investment may be made by a purchase of equity, by a loan, or by a combination of a loan and purchase of equity.

5.2 Equity

Most venture capital firms and many organized angel groups prefer to make an equity investment in a company. Depending on the stage of development of the company and the personal goals of the founders, company counsel should influence the choice of debt or equity. There are a virtually unlimited number of ways that an equity investment can be structured. The points below illustrate a number of terms that investors and the company should consider in creating the terms of an equity instrument.

- ***Preferred or Common Stock***

Most investors will require the company to issue preferred stock, although angels and individuals will sometimes accept common stock. A company may suggest that the investor accept common stock, but should not be surprised if the investor insists on preferred stock. If the company has made an S election, issuance of a second class of stock (except for a class of "non-voting" common stock) will terminate the company's S election.

- ***Voting Rights***

Preferred stock can be voting or non-voting, however, it is almost always voting stock. The voting rights of preferred stock can be structured so that preferred stock and common stock vote together as a single class, require preferred to vote as a separate class, or a combination of both. Separate class voting rights (or if multiple series of preferred stock, separate series voting rights) provide investors with a "veto" right on significant corporate actions. Sometimes the company is able to have holders of preferred stock vote together with holders of common stock as a single class. This offers the possibility that a coalition of holders of common stock and holders of preferred stock can jointly control important corporate decisions. As a practical matter, preferred stock will usually vote as a separate class for the election of the directors on a classified board (e.g. a board in which some seats are elected solely by holders of preferred stock), and on a number of matters which directly affect the economic rights of the preferred stockholders, including amendments to the charter, incurrence of debt, increasing the size of the stock option plan, and exit transactions.

- ***Dividend Rights***

Preferred stock can be designed with a variety of dividend rights and generally will carry a dividend preference. A dividend preference requires the company to pay all accrued and unpaid dividends on preferred stock prior to the payment or setting aside of any dividend on any junior stock. This generally eliminates payment of dividends on junior securities, since payment of a dividend on common stock would require payment of all accrued or accumulated dividends on the preferred stock. A dividend preference also generally requires that the company pay the holders of preferred stock a dividend equivalent to the dividend paid on a share of common stock multiplied by the number of shares of common stock issuable upon conversion of the preferred stock.

  - *Accruing Dividends* are dividends which are to be paid (a) upon conversion, (b) upon a liquidation or redemption, or (c) when, as, and if declared by the Board of Directors. Accruing dividends provide a "time based" return based on the amount of time capital is invested. Typical rates range from 6% to 12% per annum. When accruing dividends are paid at conversion, the investor may require that the dividends are paid in additional shares of common stock. This can have a significant dilutive effect on holders of common stock and the company should consider a provision that provides that the company has the option to pay accrued dividends in cash at the time that the preferred stock is converted into common stock.

  - *Cumulative Dividends* are cash dividends required to paid on a periodic basis (generally quarterly). If the company fails to pay a cumulative dividend, the unpaid dividend becomes a liability of the company (an "accumulated dividend") and must be paid at some future time. Generally, investors expect that accumulated dividends will increase the number of shares of common stock issuable upon conversion of the preferred stock, increase the amount of the liquidation payment due upon a liquidation of the company, and increase the put price if the investor has negotiated the right to require the company to repurchase the shares of preferred stock.

  - *PIK dividends* are"payment in kind" dividends. A PIK provision requires the issuance of a security – typically additional preferred stock or common stock. The issuance of securities in a PIK dividend may expose the recipient to a taxable dividend, which explains the declining popularity of PIK dividends. PIK dividends can be highly dilutive to holders of common stock, and the company should carefully model the dividend terms and consider the effect on other stockholders.

- ***Liquidation Preference***

A liquidation preference provides the holder of preferred stock the right to receive a payment "prior and in preference to" any payment or distribution of assets to holders of common stock or other junior equity securities. The definition of a "liquidation" is generally negotiated between the company and the investor, but will generally include any transaction involving a sale or all or substantially all of the assets of the company or a merger or similar transaction in which the holders of the outstanding equity securities before the merger hold less than 50% of the outstanding equity securities of the survivor of the merger. In most cases, the amount of the liquidation payment will be an amount equal to the price per share paid upon issuance of the preferred stock plus accrued and unpaid dividends. There will be circumstances in which the investor will require a liquidation payment which is a multiple (e.g. 2x or 3x) of the original issue price. This is often the case in "down round" financings or later stage financings where the total number of outstanding shares and the prospects of the company make it unlikely that the investor will be able meet their desired rate of return.

- ***Participating Preferred.***

Investors generally seek a "participating" preferred stock. Participating preferred stock means that after the liquidation preference is paid to an investor (e.g. invested capital *plus* accrued and unpaid dividends), holders of preferred stock "participate" with holders of common stock in distributions the remaining assets to be distributed to stockholders. By way of example, if holders of Preferred Stock hold a fully diluted 48% of the company's equity and holders of common stock (and options) hold 52%, the assets/transaction proceeds remaining after holders of preferred stock have been paid the liquidation preference are distributed 48% to holders of preferred stock and 52% to holders of common stock. Thus, the investor receives a distribution of the liquidation preference (invested capital and unpaid dividends), and then "participates" as a holder of common stock in the remaining assets of the company to be distributed to stockholders.

The company may seek to "cap" participation (e.g. 2x or 3x) of the original issue price. Participation can be thought of as a yield enhancement technique for the investors. A cap implies that at some exit value, yield enhancement is no longer needed. With a cap, the preferred ceases to participate. Once cap is reached, 100% of the remaining assets/transaction proceeds are distributed to holders of common stock until holders of common stock have received the same per share amount as holders of preferred stock. Thereafter, remaining assets/transaction proceeds are distributed pro-rata, and each share of preferred stock and common stock receives the same amount per share.

A capped participation can create a misalignment between the interests of holders of common stock and the holders of preferred stock. Because preferred stock "caps" out, there is a range of transaction sizes at which holders of preferred stock are "indifferent", since preferred stock will not receive any additional consideration until common stock "catches up" to the cap. Investors will sometimes point to this misalignment of interests as a justification for an uncapped participation.

- ***Conversion.***

Although preferred stock can be either convertible or nonconvertible, it is almost always convertible preferred stock. The conversion formula is the product of the number of shares to be converted multiplied by a fraction, the numerator of which is the original issue price per share, the denominator of which is the then effective conversion price. In a typical transaction, the original issue price and the initial conversion price are equal, with the result that one share of common stock is issuable upon conversion of one share of preferred stock. Generally preferred stock is convertible at the option of the holder, referred to as a "voluntary conversion" or is automatically converted into common stock upon the occurrence of one or more specified events, referred to as a "mandatory conversion". The typical events triggering a mandatory conversion are (a) a "qualifying public offering"[5] or a vote of a majority or in some cases super majority of the shares of outstanding preferred stock.

- ***Anti-Dilution***

Convertible preferred stock will contain provisions which protect it against dilution from stock splits and stock dividends. These are sometimes referred to as "event" or "organic change" adjustments and adjust the conversion price on a "proportional" basis. In addition, there will generally be a provision which will reduce the conversion price of the convertible preferred stock if the company effects a sale or deemed sale of common stock for a consideration which is less than the conversion price in effect at the time of the issuance or deemed issuance of such common stock (sometimes referred to as a "dilutive issuance"). Price protection provisions lower the conversion price of convertible preferred stock (and convertible debt instruments) so that more shares of common stock are issued upon conversion of the convertible preferred stock (or debt instrument). There are two primary types of "price" adjustments to the conversion price of convertible preferred stock (and convertible debt instruments).

5 A typical definition of a qualifying public offering specifies that offering is made pursuant to an effective registration statement and specifies both a aggregate offering size and a price per share.

- *Full Ratchet*. A full ratchet anti-dilution adjustment reduces to the conversion price of convertible preferred stock to the same price at which common stock was issued or deemed issued in the dilutive issuance. Full Ratchet anti-dilution adjustments are viewed a draconian because they don't take into account to the number of shares which were issued at the lower price. The price adjustment is the same if there is a single share issued at the lower price or if there are ten million shares issued at the lower price.

- *Weighted Average*. A weighted average anti-dilution adjustment is based on the ratio of (a) the number of outstanding shares prior to the dilutive issuance plus the number of shares that would have been issued at the conversion price in effect prior to the dilutive issuance to (b) between the number of outstanding shares after the dilutive issuance between the number of outstanding shares after the dilutive issuance. A weighted average approach attempts to maintain the "value" of the investor's investment, by adjusting the value of investor's overall ownership on a weighted average basis, taking into account the number and price of the securities issued. A weighted average anti-dilution adjustment can be effected on a "broad based" or "narrow based" method. Under a broad based method, the outstanding stock includes shares issuable upon conversion of all outstanding convertible securities, options, and warrants. Under a narrow based method the outstanding stock excludes options and warrants. The broad based method is more favorable to holders of common stock (and other junior securities), because the shares issued in the dilutive issuance are spread over a "broader" base. takes into account unexercised options and outstanding convertible notes and warrants. The "narrow" base means a smaller number of shares are deemed outstanding, and will cause a greater adjustment on the conversion price that with a broad based formula.

- Shares Excluded from anti-dilution adjustments. Regardless of the type of anti-dilution adjustment the company should seek to exclude from the anti-dilution adjustments the issuance of shares of common stock pursuant to a range of transactions, including shares issued in or pursuant to:

    - stock option plans, at least as to a specified number of shares (which are typically included in the pre-money outstanding common stock equivalents),

    - merger or share exchange, joint ventures, or to acquire technology or assets,

    - public offering, and

    - options, warrants, or convertible securities issued prior to the investment by this investor or after such investment if the conversion price was adjusted upon the issuance of the options, warrants, or convertible securities.

- ***Redemption.***

Preferred stock will generally contain a redemption provision that requires the company to repurchase the preferred stock from any investor that elects to "opt in" to the redemption for a specified price at a specified time. Such a provision is referred to as a "mandatory redemption". The typical mandatory redemption is triggered on the fifth anniversary of the original issue date. The mandatory redemption price is typically the greater of (a) the original issue price plus accrued and unpaid dividends and (b) the value determined by agreement between the investor and the company and failing such agreement, by an appraisal mechanism. The obligation of the company to repurchase the shares may be spread out over a number of years or it may require the company to repurchase all of the outstanding on the specified date. Some investors will use various mechanisms to enforce this obligation, including assuming control of the board of directors.

- ***Performance Pricing***

Although performance pricing has fallen out of favor in the last 5 years, it remains a viable alternative to bridge the gap between the valuation expectations of founders and investors. Performance pricing adjusts the conversion price of convertible preferred stock (or convertible debt) up or down if certain specified targets or milestones are met within specified time periods. Performance pricing can work two different ways. One approach is for the investor to concede to an initially higher valuation of the company than investor believes is warranted and the investor and the company agree on performance milestones and measurement times and methods, which if not obtained result in an automatic downward adjustment of the conversion price of the convertible preferred stock (or convertible debt) to a valuation which reflects the investor's expectations. An alternative approach requires agreement from the investor to accept a smaller common equity position if the company out performs the investor's projections. Under this approach, the conversion price of convertible preferred stock is increased upon the attainment of certain specified financial or operational performance milestones. This approach may appeal to investors because of the incentive to management from “earning” back ownership in the company. Investors are likely to respond to such a request by pointing out that management already has equity upside and should not receive additional “points” at the expense of the investor for doing their job.

5.3 Debt. Many options are available to structure debt instruments. Debt can provide the investor with a convenient way to reduce, over time, the risk exposure in an investment by reducing the outstanding principal balance over the life of the loan. If warrants are issued with the debt instrument, the investor may obtain repayment of principal, a current return through interest payments, and a future “equity return” in the future for a nominal additional investment. Debt is also useful if the target has made an S election and the investor is not a qualified shareholder. A debt instrument may have some or all of the following features:

- ***Secured Or Unsecured; Subordinated Or Unsubordinated***

In most cases, the company should seek unsecured, subordinated debt to preserve the ability of the company to obtain senior bank financing or incur other debt in the future. The investor will generally seek secured senior debt and restrict the ability of the company to incur any additional indebtedness prior to repayment. Secured debt means some or all of the assets of the company are pledged to secure the debt. If the debt is not repaid in accordance with its terms, the investor has the right to foreclose on the pledged assets and either sell them at a public or private sale or accept them as full payment of the loan. Subordination means that the investor agrees that other debt can be repaid before the investor’s debt is repaid.

- ***Convertible or Non Convertible***

Convertible debt is convertible, at the option of the holder, into another security, typically common stock or sometimes preferred stock. The conversion price is generally set at the current valuation of the company and is generally subject to adjustment for issuances of securities at a price per share that is less than the conversion price of the convertible debt. Sometimes the conversion price of convertible debt is expressed as a discount to the price in a “qualified financing”. The purpose of such a provision is permit an earlier investor to take advantage of the valuation and pricing established by “professional” investor in a subsequent financing with an appropriate discount for the additional risk exposure an earlier investment.

Another approach used in a debt financing, is to issue non-convertible debt with a warrant at a nominal exercise price. In such a structure, the company repays the indebtedness with interest, and the investor has the right to obtain an equity position in the company by exercising the warrant at a nominal exercise price, such as $.01 per share. If the investor insists on a non-convertible debt instrument with a warrant at a nominal exercise price, company counsel should attempt to negotiate a smaller warrant position in light of the reduced risk of the investment if the principal is in fact repaid.

- ***Fixed Rate Of Interest Or Variable***

The interest rate for a debt financing can be set as a fixed rate or the rated can be set to adjust with changes in a specified index such as Wall Street Journal Money Rates column “Prime Rate”. Another approach is for the interest rate to increase over time to provide maximum incentive for the company to repay the obligation. An increasing rate structure may be based with or without reference to an index. For example, the interest rate increases by a half-point per quarter after some period of time. Investors ask for this feature believing it “encourages” the company to repay or refinance the debt. Company counsel should carefully review the usury implications of this feature.

- ***Structure of Interest Payments***

The interest in a debt financing can (a) accrue until maturity, (b) be paid in cash at specified intervals (e.g., monthly, quarterly, or annually), or (c) paid by issuance of notes or securities – (PIK interest). The company should be aware that a note in which the interest accrues and is paid at maturity may be subject to the original issue discount rules (“OID”). The OID rules may require the investor to report and pay income taxes on a calculated amount of accrued interest, typically the so-called “applicable federal rate”.[6] Most early state companies don’t have sufficient cash flow to invest in the grow of the business and to make current interest payments, so a debt structure that requires current interest payments may not be appropriate. PIK interest payments are useful when the company’s cash flow is insufficient to make regular interest payments. In its simplest form, the company, in lieu of making a cash interest payment, issues a note or other security in the principal amount of the interest payment. PIK interest may have adverse tax implications for the investor.

- ***Structure of Principal Payments***

Most early stage companies don’t have cash flow sufficient to re-invest in the business and repay indebtedness. Typically, a debt instrument will be structured to re-pay principal at maturity. The company might seek to have the maturity of the note defined as an exit transaction or an equity financing transaction rather than as a stated date to ensure that the note does not become due until there is a transaction that will generate sufficient proceeds to repay the debt.

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[6] ***See*** §1272 of the Internal Revenue Code of 1986.

- ***Events Of Default***
    - Payment Defaults
    - Covenant Defaults
    - Other Defaults

5.4 Warrants

Warrants can play an important role in a financing transaction. The usual context for warrants is a transaction in which the investor makes an investment by means of nonconvertible debt or nonconvertible preferred stock. Warrants will generally contain anti-dilution adjustments for both "organic" and "price" events. Warrant anti-dilution adjustments differ from the anti-dilution adjustments for convertible preferred stock because both the exercise price *and* number of shares issuable upon exercise of the warrant are adjusted. Warrants may be issued for a specific number of shares or for a percentage of the then outstanding shares of stock. The company should seek to have a specified number of shares issued upon exercise of the warrant rather than a percentage of the issued and outstanding stock, because the warrant holder avoids dilution occasioned by all issuances or deemed issuances of common stock at a price greater than the exercise price. All dilution is shifted to the founders and other holders of common stock.

5.5 Exit Strategy

Investors generally expect that the company will either go public, sell to another company, or recapitalize through a management buy-out or other transaction in which the investor's interest in the company is repurchased or "taken out" within a three to seven year time frame. Investors will insist that the financing documents cover all three potential exit strategies. The latter two exit strategies are handled through the "liquidation" preference in preferred stock or a "due on sale" provision in debt. The first exit strategy is handled by the grant of demand and piggy-back registration rights to the investor. Demand registration rights permit the investor to "demand" that the company file a registration statement with the Securities Exchange Commission and effect a public offering of its common stock.

5.6 Structured Returns

Some investors prefer to acquire common or preferred stock, sell it years later, and realize capital gains on the transaction. In contrast, other investors prefer to have their returns "structured" over the life of the investment. The most common means of structured returns are periodic payments of dividends or interest. Investors who desire structured returns will also seek to have a portion of the invested capital repaid periodically to reduce the risk of the investment over time. Such investors will almost always have their equity upside covered by issuance of a warrant exercisable at a nominal cost. Company counsel should understand which type of return the investor is seeking before attempting to negotiate the terms of the transaction.

6. Corporate Governance Considerations

In addition to the economic terms discussed above, investors generally expect a wide variety of control rights over the strategic direction, and in some cases daily operation, of the company. After negotiating the economic terms, the founders and the company counsel often have the reaction that nothing could be worse than what has just transpired. Unfortunately, nothing could be further from the truth. From the founders perspective, one of the more distasteful aspects of taking on investors are the “command” and “control” provisions required by investors. In some cases, these are required in order for venture capital funds to qualify for the venture capital operating company exemption and in other cases, they are simply good business practices enabling investors to have control over their investment.

6.1 Board Representation.

Most investors require one or more seats on the Board of Directors. Representation on the Board of Directors can be effected in the case of voting preferred stock by class voting. Alternatively, board representation can be effected by a voting agreement. A voting agreement requires holders of voting securities to vote all shares, the voting of which is under the control or influence of a person or persons designated by the investor. The company should seek to include a provision which allows the removal of an investor representative if his or her continued service is not in the best interest of the company. For example, this could occur if the investor's representative is implicated in an SEC cease and desist order, is party to securities or other fraud allegations, or other similar circumstances. Company counsel might also ask for the right to “approve” or “consent” to the investor representative.

6.2 Stock Control

The most difficult provisions to negotiate in private capital transactions are the attempts by investor to “lock up” common stock held by management and founders. Listed below are a number of stock control mechanisms which company counsel will be asked to negotiate. Usually, none of these restrictions apply to shares held by the investor.

- ***Restrictions on Transfer and Rights of First Refusal.***

Stock restrictions are universally requested. The investor typically suggests that these provisions insure that the investor will be dealing with the management team that convinced him to invest in the first place. The most common restrictions on transfer provide for no disposition (broadly to defined to include any sale transfer, bequest, gift, or hypothecation) except for so-called “permitted dispositions”. Generally, a “permitted disposition” will be limited to a transfer effected after compliance with a right of first refusal in favor of the investor, the company, and perhaps other shareholders, or a transfer effected upon a termination of employment.

- ***Co-Sale (the “Take-along”).***

A co-sale right is an option in favor of the investor to sell a portion of the investor's shares whenever a founder or management sells a portion of their shares. Co-sale rights are intended to (a) provide liquidity to the investors and (b) limit the opportunities of the selling shareholder to dispose of shares. Typically, once the right of first refusal has expired unexercised, the co-sale right requires the selling shareholder to require the purchaser of the selling shareholder's shares to offer to purchase an equivalent percentage of shares from the investor at the same price and terms such purchaser requires shares from the selling shareholder.

- ***Forced Sale (the “Drag-along”)***

Investors will typically require a provision that forces all shareholders to sell the same percentage of their shares as the investor and at the same price and terms, to an unaffiliated purchaser to whom investor is selling the investors shares. This provision effectively enables the investors to sell the company over the objections of the other shareholders and in most, if not all, jurisdictions eliminates dissenter's rights. The company can offer an argument that such a provision is contrary to the mandatory put right, and therefore unnecessary.

- ***Founders Stock Restrictions – ("Reverse vesting")***

Founders stock control is desired by investors (a) to incentivize management and founders, (b) to prevent dilution to the investor in the event that management is replaced, and (c) to maintain stock ownership in the hands of employee founders rather than non-employee founders. The typical founder stock restriction provisions require the subject founder to sell to the company all or part of the shares of stock held by such shareholder upon a termination of employment. If the shares are "portable" the number of shares that the founder is required to sell is determined by the "vesting schedule". If the shares are not portable, then all shares are sold to the company, with shares that are "vested" being purchased at fair market value (usually determined by the Board of Directors, a recent 409A valuation, or a formula) and shares which are "unvested" being purchased at cost (or forfeited) or some other agreed upon amount. If termination of employment results from death or disability, the company might suggest that the repurchase right be the fair market value or the amount received from life insurance. In the event the termination of employment is for "cause" the investor might request that all shares be purchased for nominal price. Generally, the investor will request that the company have the right to pay all or part of the purchase price by an unsecured promissory note. In circumstances in which these provisions are requested, the company might request a "claw back right." A typical claw back requires that the company pay the per share differential between the price paid on the "vested shares" upon termination of employment and the price realized by the company in a public offering or a liquidation. While this is not as beneficial to the subject shareholder as holding the securities for appreciation, it does place him in an economic footing which is roughly comparable to the position he would have been in had termination of employment occurred contemporaneously with the public offering or liquidation. Many investors are unwilling to provide clawback rights for more than a limited period of time, on the theory that new management created the increased value over the value at the date of termination of employment, not the founding manager.

- ***Rights to Purchase "New" Securities ("contractual pre-emptive right")***

Investors will generally ask for the right to purchase "new" issuances of securities. This right of first refusal comes in two basic varieties, (a) a contractual pre-emptive right, or the right to purchase a pro rata share of any new issuance of securities and (b) the right to purchase all new securities. This latter approach should be resisted by company counsel because it makes it difficult to attract new investors. Company counsel should also seek to exclude certain types of issuances from the right of first refusal, including stock issued in asset acquisition, merger and share exchanges, stock issued in financing transactions or issued for a property other than cash, and stock issued to employees pursuant to stock option plans.

6.3 Special Class Voting Rights/Veto Rights over Major Decisions

Other commonly requested corporate governance provision are special restrictions on issuance of additional securities, redemption of any junior securities, entering into any agreement in respect of or consummating any merger, asset sale, or similar transaction, amending the articles of incorporation or bylaws, change in strategic direction of the business, entering into transaction with affiliates of the company or founders or management, and increasing the compensation of management in excess of that set forth in any employment agreement. If the investment is made in preferred stock, these provisions are typically contained in the charter.

6.4 Springing Board Representation

Occasionally, the investor will seek to have a mechanism to provide total overall control of the company upon the occurrence of significant adverse events. One tool which can be used to effect this control is the "expanding" board of directors. The typical provision will define one or more "triggering events". Upon the occurrence of a triggering event, the number of persons constituting the board of directors automatically expands. The directors elected by the investors are authorized to fill the vacancies created by the expansion and in some cases to remove sufficient number of the former directors so that representatives appointed by the investor constitute a majority of the board. Director conflict of interest transactions are suggested by such a scenario, however, the investor will typically point out that directors appointed by founders have similar conflicts of interest, and that the investor's senior position justifies assuming control of the company.

7. Maintaining Control of Investment (and VCOC considerations)

7.1 Information Rights

The investor will request that the company deliver monthly, quarterly, and annual financial statements, an annual operating budget, a quarterly narrative report which discusses material deviations from the operating budget, copies of lawsuits served on the company, and other similar items of information.

7.2 Operating Covenants

The investor may ask for operating covenants such as financial ratio compliance (rare in equity transactions), maintenance of corporate existence, maintenance of adequate insurance, prohibition of restrictive agreements, access to information and inspection rights, reimbursement of expenses of directors, compliance with laws, maintenance of books and records of account, limitations on employee stock plans, requirement for employee proprietary information and inventions agreements, and prohibitions on becoming a United States Real Property Holding corporation.

7.3 Employment Agreements

The investor may also insist on an employment agreement which contains confidential information non-solicitation, and non-competition covenants.

8. Conclusion

Raising capital for an early or expansion stage company can be daunting and time consuming. It will require compliance with numerous federal and state laws.

About the author

Gerry Balboni is a corporate transactions attorney with over twenty years of experience representing companies and individuals that buy, sell, and invest in growth businesses. Gerry works with companies seeking capital, venture capital and private equity funds, buyers and sellers of businesses, and licensors and licensees of technology and software. Gerry also provides assistance in SaaS and cloud licensing, data privacy and security, intellectual property protection, non-competition agreements, executive compensation, stock options, restricted stock awards, software and encryption export regulation, and strategic alliances.

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