Venture Capital

A Practical Guidebook for Capital-Seeking Business Owners, Managers and Advisors

Daniel H. Aronson
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A Practical Guidebook for Capital-Seeking Business Owners, Managers, and Advisors

by

Daniel H. Aronson

Greenberg Traurig, P.A.

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VENTURE CAPITAL:
A PRACTICAL GUIDEBOOK FOR CAPITAL-SEEKING BUSINESS OWNERS, MANAGERS, AND ADVISORS

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INTRODUCTION

Venture capital: more art than science, more journey than destination, and clearly much more than merely a financing transaction.

Starting, nurturing, and developing a business, finding and enlisting the right management team, partners, and advisors, obtaining stage-appropriate funding, exploiting alliance and growth opportunities and, ultimately, executing on an exit strategy are all parts of a dynamic and challenging process which, in many ways, defies common or business sense and the skill set of many entrepreneurs and business owners. Raising equity capital at the various stages of a company's development is particularly tricky and troublesome for the uninitiated.

This GUIDEBOOK is intended as an introduction to the process of finding and securing venture capital funding for an early-stage or emerging business, as well as a primer and refresher course for more seasoned companies that continue to seek institutional equity funding. While not an exhaustive treatment of the subject, it is designed to provide practical information and helpful pointers to entrepreneurs, owners, managers, and advisors on their journey to source, negotiate, document, and close one or more equity funding rounds with sophisticated investors.

Two annexes serve as resources to aid the capital-seeking business owner and manager: ANNEX A is an illustrative and annotated term sheet for a Series A preferred stock investment financing, suggesting possible terms (and their implications) from both the investor's and the company's position. ANNEX B offers a glossary of venture capital terms, phrases, and jargon, which should assist in navigating and understanding the many unique (and sometimes bizarre) terms often used by participants in venture capital negotiations and transactions. Readers should refer to these resources, as appropriate, throughout their review of this GUIDEBOOK.

There are many obstacles to avoid, challenges to overcome, and opportunities to seize upon over the course of the capital-raising journey. Funding is typically raised in stages (and over the life of a business's development), with each "raise" viewed not in isolation but rather as part of a larger, overall development and capitalization process. Of course, there is no substitute for proven, talented, dedicated managers; committed, aligned partners; and experienced, deal-tested advisors—not to mention a fair sprinkling of luck—in achieving success in the development and funding of an emerging business.

SECTION I:

Sources of Capital

When access to funding is vital to a business's growth and development (as it often is), the business owner must make a careful evaluation of the available options. An emerging business can seek to obtain needed capital in a number of ways, and no one source of capital will always be best. The business owner's ultimate decision of which source (or combination of sources) to tap at any particular time will require a balancing of considerations, including the advantages, disadvantages, and requirements of each source (not to mention what's reasonably available). This section surveys the principal funding alternatives.

Owners; Friends and Family

The simplest and most direct source of capital for a business is funds from existing owners. *Owner-funding* occurs in virtually every emerging business and is a critical first step in the capital-raising process. The main benefits of using existing owners' funds are the ease and speed with which money can be raised (with relatively little complication and expense) and the maintenance of control of the business by the existing ownership group. Using owner-funding also delays outside ownership (and, therefore, dilution of existing ownership, control, and other issues) until a later, hopefully higher, valuation plateau is reached. Financing through owner-funding also serves as a tangible demonstration of the owners' or founders' commitment to the business (a factor of significance to most venture capitalists). The most significant disadvantage of owner-funding is that this source of capital is usually quite limited and will not satisfy the business's ongoing capital needs.

Most emerging businesses also seek and receive funding, particularly at the early stages, from family members and friends of the founders and existing owners. This *friends & family funding* offers the advantages of speed, simplicity, favorable valuation and terms, and expansion of stockholder ownership, on a limited basis, to known and friendly sources. On the other hand, raising capital from friends and family might give rise to personal conflicts and issues. Additionally, existing owners could be viewed as taking advantage of the relationship with such friends and family or their lack of sophistication, experience, or insight into the funding process (including on matters such as valuation and terms). Finally, uninitiated investors (thought to be friendly) may bring unrealistic expectations and even demands regarding the amount and timing of potential returns on investment, the need for and difficulty in raising subsequent rounds, and delays and extended time-frames in achieving business profitability or any real exit transaction.

Earnings (Company-Generated Funding)

Internal earnings and cash flow often are not thought of as a source of capital for the company in need of funding. If sufficient and if managed properly and effectively, earnings and cash flow can and sometimes do provide interim funding for limited development and growth. In fact, proof that a business can live and grow within its means for some period may be important to venture capital investors.

Typically, however, for a business pursuing a high-growth strategy or otherwise requiring significant capital, funds from earnings and cash flow will not be sufficient to meet the business's critical, ongoing needs (in areas such as research, development, expansion, retooling, marketing and sales, growth through acquisitions, or other capital-intensive campaigns). In addition, internally generated funds may not provide a consistent or reliable funding source and, if looked to as the sole source of funding, could leave the business unable to take advantage of important opportunities as and when they arise.

Commercial and Bank Loans; Government Loans and Aid

First, a comparison of debt/loans and equity/stock financing is useful. The principal advantage of debt financing is that the business owner is able to maintain and avoid dilution of his or her

equity interest (ownership, control, and upside potential). In addition, the interest costs of debt financing are known (or calculable) and are tax-deductible; and debt holders have no claim on future earnings, or growth and success in the business franchise, once the debt is paid off. The main disadvantage of debt financing is that the business owes the debt (*i.e.*, it is reflected as a liability on the balance sheet) and must pay it back, principal plus interest, on a scheduled basis. Required debt payments reduce cash flow and profits, and dire consequences can follow non-compliance with debt covenants (of which there can be many). For example, failure to make a timely payment can result in losing control of the business to debt holders.

Equity, on the other hand, is long-term capital, which does not require repayment absent some special redemption requirement or similar feature. By adding to net worth, equity improves a business's creditworthiness (which can improve payment terms from vendors and enable or facilitate lease financing or even bank borrowing). Additionally, an equity investment from a sophisticated financing source connotes external validation of the company's business model by a (presumably) objective outsider. Of course, the impact of this stamp of approval is greater if the investment comes from a recognized, reputable funding source. Also, equity investors, unlike many commercial lenders, usually do not impose personal liability on owners and do not take a security interest in the company's assets. The unlimited upside benefit and potential of equity (combined with certain preference features), as opposed to debt with its fixed and limited payments and returns, is what motivates venture capital investors to fund emerging businesses. Of course, debt and equity funding are not mutually exclusive. Most businesses, over time, utilize a mixed balance of both.

Banks and other commercial lenders can provide a source of capital to growing businesses beyond the seed and development stages. For the most part, banks look to asset and security-based lending, and not future cash flow or prospect-based lending. Thus, most early-stage and emerging businesses will find it difficult, if not impossible, to satisfy prevailing lending criteria—including providing security, an equity cushion, and ample cash flow for the timely repayment of principal and interest. As a result, in the early stages, unless hard-asset security and appropriate personal guarantees are provided, this route will likely not be available.

An emerging or early-stage business may also want to consider seeking loans or other financing from the Small Business Administration (SBA) and other government sources. Recently, there have been a number of efforts to increase the funding available to small businesses and to ease and reduce the complex criteria, paperwork, and review required to obtain government financial assistance. SBA-guaranteed loans may be available at lower interest rates and with less recourse risk and longer maturities (and other more favorable terms) than typical bank or commercial loans. This option can prove to be worthwhile for the right company—one that can both satisfy the applicable criteria and tackle the funding process. Government financing, though, is simply not available for many businesses and—given the extensive and time-consuming application, evaluation, and qualification process—requires patience, diligence, and some measure of endurance. For the most part, this is a longer-term option, best combined with other avenues for raising funding.

In 1958, Congress created the Small Business Investment Company (SBIC) program. SBICs, licensed by the SBA, are privately owned and managed investment firms. With their own capital and with funds borrowed at favorable rates through the federal government, SBICs can provide growth capital and loans to small businesses, both new and already established, in order "to build bridges of support between private equity investors and small companies and communities across the country."[1]

Strategic Alliances; Joint Ventures

A strategic alliance, partnership, or joint venture with an established operating company may also serve as a means to raise needed capital (or to avoid having to raise capital for specific functions or needs that can instead be provided by the partner). Typically, in such a case, the established company is interested in some aspect of the capital-seeking business, such as its proprietary position, technology potential, product/market channels, location in the manufacture/distribution chain, or potential as a customer. A strategic alliance usually serves to facilitate the achievement of goals other than raising capital, including access to research and development, new technology, manufacturing capabilities, distri-

1. For further information on the Small Business Administration and SBICs, visit the SBA's website at *www.sba.gov/INV*.

bution channels and markets, customers, and management personnel, as well as an enhanced ability to compete.

Funding can also be provided through strategic arrangements and relationships with customers, vendors, suppliers, and others with whom the company does business or who are familiar with the company's business, products, services, capabilities, and market. Capital-related advantages can also be obtained by acquiring or adding symbiotic or value-added businesses, services, or product lines, or by disposing of (or discontinuing) non-core or "drag" businesses, services, or product lines.

Tread carefully: For the emerging business, the strategic partner—which is pursuing the arrangement to satisfy its own interests and goals—typically has far greater experience and resources, and those resources can be deployed (with great vigor) if a dispute or conflict arises. The alliance can and often does limit the fund-seeking business's flexibility to pursue its natural business course, or to engage in future alliances, acquisitions, and capital transactions. Furthermore, the emerging business may find itself controlled, or its future substantially affected or limited, by a much larger company focused on its own agenda and priorities, which may not include, as the highest priority or at the most critical time, the successful growth and development of the emerging business. In any strategic alliance, the protection of the business's confidential and proprietary information (which must be shared at some point in the evaluation process and beyond) presents complex and difficult issues which must be evaluated, planned for, and addressed with great care.

If an emerging business is pursuing a strategic alliance solely or even primarily to raise capital, it probably should not be considering the alliance at all. Successful alliances are often "bet-the-business" transactions, which require a common vision in a joint enterprise, as well as a substantial commitment from management and personnel and the devotion of (often scarce) time, attention, and resources. Before entering into a strategic alliance, management should carefully consider, together with experienced advisors, issues such as flexibility to operate and grow the business, now and in the future, protection/control of intellectual property and other assets (which may be key to the business's upside potential), and freedom to pursue later affiliations, growth, financings, and exit strategies.

Private Placements

One of the more traditional, tried-and-true methods of raising equity capital is the private sale of securities to a limited number of (typically unaffiliated) investors. Depending upon the circumstances, a private placement can be a cost-effective means of raising capital, usually at later stages of development. Private sales of securities may be accomplished with or without engaging a placement agent. Business owners should proceed cautiously before engaging a placement agent, and research any such agent's background for appropriate qualifications (including regulatory requirements applicable to those who assist in selling securities for fee compensation) and recent, relevant experience with similar companies. Before engaging a placement agent, the company should negotiate and document the terms of the engagement, including fees, expense reimbursement, warrants (if any), term and termination, performance requirements, and any exclusive or *fee tail* provisions.

Expect the private offering process to take significant time and resources, including to consider and engage a placement agent, prepare an offering memorandum, identify suitable investors, conduct a road show (management presentation) of sorts, circle investors' interest, negotiate terms (including investors' rights), prepare and finalize documentation, and close the transaction. Also, the business will likely be subject to—and thus management will need to prepare for—a rather extensive due diligence investigation.

From a business perspective, private placements have some elements of both venture capital transactions and initial public offerings. Compared to an initial public offering, the private placement typically requires less due diligence, preparation, and documentation by the company/issuer and is subject to far less regulation (e.g., no disclosure filing must be submitted for SEC review) and expense; compared to a venture capital transaction, the private placement usually requires less due diligence and documentation by the company and generally involves less negotiation and revision of documents. In many cases, if the private placement offering is not pre-sold or conducted by a reputable, experienced placement agent with a solid, relevant track record, the company faces a greater risk of non-consummation, after substantial effort and expense, than it might with other alternatives.

Securities Law Compliance for Private Placements: What You Need to Know

Venture capital transactions involve the issuance and sale of securities (typically, preferred stock). As such, they are subject to a regulatory process—and the related compliance issues—under both federal and state securities laws. For transactions where the only offerees and purchasers are substantial, established, domestic VC funds and where no compensation is being paid to any *finders,* employees, or others in connection with the financing, compliance is rather straightforward. It can be handled by experienced counsel through the offering, documentation, and closing process. Nevertheless, as in any equity funding, a plan must be designed and implemented to address compliance issues. A primer on some of the most significant considerations follows.

For starters, every issuance and sale of securities in the United States (or, more specifically, relying on or using US interstate commerce) must either be registered through the appropriate filing and registration process with the Securities and Exchange Commission ("SEC") or qualify for an applicable and available exemption from registration. Given the expense, timing, and burdens associated with the registration process, it is vitally important to qualify for an applicable exemption (unless you truly desire to register, after a full appreciation of the costs, requirements, and implications).

The private offering exemption, provided under Section 4(2) of the Securities Act of 1933 (the "1933 Act"), is clearly the most common exemption on which emerging businesses rely in offering and selling their securities (whether preferred and common stock, warrants, or notes). Unfortunately, Section 4(2), which exempts "transactions by an issuer not involving any public offering," provides no real guidance as to how to comply with the exemption. After many requests and much prodding, the SEC promulgated Regulation D (hereafter "Reg D") in 1982. It provides three operative transactional safe harbors, which permit companies, with relative certainty, to meet the Section 4(2) exemption from registration. Through Reg D, the SEC has promulgated rules that allow the sale of billions of dollars of securities by hundreds of companies (referred to as *issuers*) each year without public registration.

Here are some highlights of Reg D and its safe harbor transactional exemptions from registration:

- The safe harbor is not exclusive. For issuers unable to comply with the strict requirements of the regulation, Section 4(2) continues to be available for sales to offerees who are capable of "fending for themselves" (per the 1953 Supreme Court *Ralston Purina* case) if they are provided with information enabling an informed investment decision.
- Section 4(2) and Rule 506 apply only to issuers. Subsequent sales (known as *resales*) are restricted and may be effected only in reliance on another, separate exemption from registration.
- Rule 504, for issues of $1 million or less, and Rule 505, for issues of $5 million or less, were adopted pursuant to the SEC's exemptive authority under 1933 Act Section 3(b).
- Rule 506, for issues of any dollar amount, is clearly the most common safe harbor in venture capital and substantial private placement transactions. It has the following elements:
  - ≈ Unlimited dollar amount of offering.
  - ≈ Purchasers limited to an unlimited number of *accredited investors* plus up to 35 non-accredited (but "sophisticated") investors. Accredited investors (as judged at the time of sale) include: banks; broker-dealers; insurance companies; trusts and other entities with more than $5 million in assets (not formed solely for purposes of the investment); directors and executive officers of the issuer; and wealthy individuals (*i.e.*, persons with a net worth—alone or with a spouse—of more than $1 million, or with annual income of $200,000 individually/$300,000 jointly with spouse in each of the two prior years).
  - ≈ No informational requirements for accredited investors, but specific, rather extensive information (which varies based on the issuer's nature and offering size) must be provided to each non-accredited investor.
  - ≈ General advertising is prohibited, as well as solicitation (including "conditioning the market") by the issuer or its representatives that publicizes the offering or is designed to attract investor interest.
  - ≈ Resales of securities are restricted, and precautions must be undertaken to prevent non-exempt resales.

≈ Form D must be filed within 15 days after the first sale of securities (this filing is required to ensure a valid Rule 506 exemption and to ensure exemption from certain state securities law requirements).

- The *anti-fraud rules* apply to all exempt offerings. Accordingly, disclosures, information, and communications connected with the offer or sale of securities should be carefully prepared and scrutinized for possible errors, misstatements, and omissions.

- The burden of proving compliance with any registration exemption (and ***all*** of its applicable requirements) lies with the issuer; accordingly, the issuer must know the rules and keep good records regarding compliance.

- State securities laws (also called "blue sky laws") in states in which any purchaser of securities is deemed to reside must also be reviewed, considered, and met, on a state-by-state basis. Rule 506-compliant offerings (but ***not*** other Section 4(2) exempt offerings) preempt state securities laws (as a result of the National Securities Markets Improvement Act of 1996), except for applicable mandated notice filings and fee requirements. For all states other than New York, post-sale notice filings (which largely coordinate with the Form D filing) may be made; New York still insists on pre-offer filings. Particularly thorny issues can arise under state securities laws any time a person is compensated in connection with the offer or sale of securities.

- Beware of *integration*: When two or more offerings, which appear to be exempt when considered separately, take place in relatively close proximity, they might be bundled or viewed as a single non-exempt transaction (and one bad apple can spoil the entire barrel in this context). Rule 502 provides a safe harbor from integration for offerings completed six months before or started six months after other offerings of securities of a similar class.

- Failure to satisfy an exemption from registration (whether through Reg D, Section 4(2), or otherwise) can have serious consequences, not the least of which are a right of rescission for the purchasers (*i.e.*, the right to get all of their purchase money back), a possible injunction against the offering while in progress, and possible civil or criminal investigations and proceedings (with related fines and penalties) initiated by the SEC or other regulatory authorities.

Private placements must be structured to satisfy available exemptions from the registration requirements of federal and state ("blue sky") securities laws and regulations. These regulations—which are currently being studied and reconsidered in significant respects by the SEC—apply to and strictly regulate the offering process, offeree suitability, disclosure and information requirements, publicity and communications, and the sale (and resale) of the business's securities.

Venture Capital

Venture capital funding is, simply put, risk-equity investing by professionally managed investment funds, providing seed, early-stage, and later-stage funding to high-growth private companies (from small start-ups to larger, more mature businesses). Venture capital has served as both an important engine of US macroeconomic growth and a driving force in the commercialization of science and technology. The venture capital market provides a critical link between finance and innovation, by providing fund-seeking businesses with access to a pool of capital specially attuned and equipped to invest in early-stage and high-risk ventures. Venture capital funding always involves a longer-term, illiquid equity investment in a company believed to have exceptional growth potential (and exit opportunities). These investments are usually structured as the purchase of convertible preferred securities (sometimes combined with subordinated, unsecured debt).

In addition to needed funding, a venture capital investment can and should bring an important partner, resource, and discipline to the business—in such areas as management recruitment, future financings, strategy, sales and marketing, budgeting, industry best practices, plan execution, and exit strategies—depending upon the venture investors' background and experience, as well as the chemistry and fit with the investor. Venture capital investments are made by professionally managed venture capital funds (which hereafter are referred to as "VCs") but also may be made by established companies (often, through an investment subsidiary or division), investment companies, investment funds, insurance companies, and wealthy individuals (the so-called angel investor[2]).

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2. See *Angel Investing,* beginning on page 56.

VC firms are typically organized as limited partnership funds, which raise money from large institutional investors and very wealthy individuals. In the late 1960s, venture capital was considered—by the few who took interest—as an asset pool with approximately $3.0 billion in total assets; today, venture capital is a mainstream asset class, with more than $70 billion in assets under management. Venture capital investors are said to have target, compound (annual) investment returns in the 30% and greater range. (During the late 1990s, returns reached the 50%+ range; from 2000-2003, any positive return at all, on an annual basis, would have been considered a not-insignificant victory.) Given that VC investors have professional management (and discipline) and that portfolio investments (*i.e.,* investments in other companies) carry a high degree of risk and lack of liquidity (or available exit strategy), expect sourcing venture capital to involve substantial due diligence; intensive business, strategic, and financial planning; and aggressive negotiation of valuation, deal structure, preferential rights, and terms. This GUIDEBOOK contains an expansive discussion of venture capital transactions in Section II.

Going Public—The IPO

The initial offer and sale by a company, through one or more lead underwriters and a syndicate of underwriting firms, of its publicly tradable common shares to a large number of public investors is known as an initial public offering or IPO. An IPO is effected by means of a detailed disclosure document, called a *prospectus*. This is included in a *registration statement* that is filed with, reviewed by, and eventually (the issuer hopes) declared effective by the Securities and Exchange Commission. The shares are typically also listed or quoted on a stock exchange or quotation system, most prominently the New York Stock Exchange (or "Big Board") or NASDAQ Stock Market.[3]

As part of an IPO, the managing underwriters conduct a marketing program (known as the *road show),* following the preparation, printing, and distribution of a preliminary prospectus (known as a *red herring).* Ultimately, if successful, the IPO is priced and

3. The shares registered in most VC-backed IPOs are listed on NASDAQ *(i.e.,* The Nasdaq Stock Market).

closed with the sale and public trading of registered shares, and with the net proceeds going to the company and, in some cases, also to selling stockholders.

In recent years, the IPO market has been challenged, as it regains steam from the doldrums of the "bubble burst" and economic recession. Once a company is public, the burdens of the regulatory regime for the public company and its officers, directors, and significant stockholders are extreme (and extremely time-consuming and expensive). Given the substantial effort, expense, and risks—and the extensive preparations, restrictions, and disclosures—involved, the IPO route is clearly not available or appropriate for every company, management team, or business owner.

No amount of advance planning can overcome an unreceptive or adverse stock market. Market receptiveness to IPOs, in general or in your industry, can change quickly and dramatically, so timing is everything. When appropriate, well managed, and successful, an IPO can be an efficient and effective means of raising substantial equity capital (at closing and in the future), providing funding, liquidity, increased net worth, employee compensation and acquisition currency, name recognition, and other advantages, but various risks, costs, and disadvantages must be considered as well.[4]

PRACTICAL TIP:

> Choosing the right source of funding for your business is neither a one-time nor a one-size-fits-all matter; it is part of a dynamic, ongoing process. With each round, educate yourself on the alternatives realistically available and the relevant players, and focus your search, with the assistance of advisors and gatekeepers, on those sources or combination of sources that offer the best fit with your specific funding needs, development stage, management team, resources, industry, and plans.

4. For a detailed discussion concerning IPOs and the public offering process, see *The Initial Public Offering: A Guidebook for Executives and Boards of Directors* (2004; Bowne SecuritiesConnect Publications); available for download at *www.bowne.com/bsc/pubs_ipo.asp*.

SECTION II:

Venture Capital Funding

Venture capital investing, as noted above, is more art than science, and more a process or journey than an end result or destination. There is no standard, accepted definition of what constitutes *venture capital.* As addressed in these materials, venture capital is risk-equity investing by professionally managed investment funds in pursuit of extraordinary, long-term financial returns through equity investment, ownership, and involvement in start-up, early-stage, later-stage, and high-growth private companies.[1] The practice of venture capital defies easy definition, reflecting the breadth and diversity of both venture capitalists (and other sophisticated private equity investors) and the companies they invest in. Venture capital (again, for purposes of this GUIDEBOOK) does not include a variety of other popular venture or investment strategies, such as bridge financing for an IPO, buyouts, turnaround investments in troubled companies, or investments in large, mature companies.

We should be clear on one thing from the start: It is extremely difficult to obtain venture capital funding, and venture capital is not (and should not be) for every emerging or growing business. Only a small fraction of the ventures that pursue VC investment ultimately receive such funding. VC fund representatives (who must devote attention to numerous tasks and functions, including nurturing, developing, and cultivating exits for existing portfolio companies) have limited time and resources to devote to sourcing new investments. Accordingly, capital-seeking business owners are well-advised to educate themselves regarding the process and

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1. For a glossary of terms, jargon, and phrases commonly encountered in venture capital transactions, see ANNEX B, *Glossary of Venture Capital Terms and Jargon,* beginning on page B-1.

dynamics of venture funding (in particular, what VC investors are looking for and why), and to plan and prepare themselves in order to maximize the possibility of attracting real and sustained venture fund interest, surviving a rigorous due diligence examination, arriving at a fair and appropriate valuation, negotiating the terms and conditions of the transaction, and, ultimately, closing on the funding they seek.

Pursuing Venture Capital: Opportunities & Challenges

There are several advantages intrinsic to venture capital as a source of equity funding. First, a VC firm provides a single source of substantial equity funding with little, if any, regulation or red tape. Additionally, VC investors can and should be value-added partners, providing access to and assistance with important drivers of business growth and success. This includes providing discipline in such areas as corporate strategy, governance, budgeting, and achievement of milestones; strategic, operational, and financial advice (gleaned, hopefully, from experience with similar portfolio companies operating in your industry); help with management recruitment and retention; introductions to potential customers, suppliers, partners, and acquisition prospects (including through other portfolio investments); assistance with future financing rounds and introductions to financing sources and investment bankers; and guidance with exit/liquidity strategies. Finally, VC funds are sophisticated and experienced (serial) investors and can be expected to conduct themselves professionally and not to waste your time. Through your advisory team's network (and experience and available data bases), you can learn about and evaluate the history, approach, focus, commitment, and track record of most VC investors.

On the other hand, the process of accessing venture capital is not like hitting a light switch: it oftentimes involves a somewhat lengthy, difficult, and trying process (particularly for the first go-around). Again, only a small fraction of submitted or reviewed business plans actually results in VC funding, and many successful private companies are not appropriate for venture capital investment. Given this, sourcing **needed** funding via a venture capital investment is rarely recommended as the sole planned course (and, until an acceptable term sheet or letter of intent is signed, other sources or arrangements should be pursued as well). Getting

introduced to, holding meetings with, and capturing the interest of appropriate VC investors takes time (sometimes months), persistence, and sustained effort (not to mention the ability to weather a few disappointments).

Because of the experience and sophistication of VC representatives and the requirements of VC funds (and the fact that you can only make a first impression once), the company will need to undergo substantial internal planning and preparation as a prelude to a VC funding round and to prepare for its transition to becoming a portfolio company (with one or more sophisticated, focused, and independent stockholders). This includes undertaking corporate housekeeping, management team building, business planning, accounting/financial statement/audit work, and financial budgets and forecasts; polishing your executive summary and pitch; addressing arrangements and transactions with affiliates; paying attention to contracts and regulatory matters; and preparing to face extensive due diligence requests and inquiries.

VC funding is also viewed by many as expensive money, since venture capital investors are highly skilled valuation and transaction negotiators who seek extraordinary financial returns and typically require rather complex and extensive investment, preference, governance, and exit protections. In a typical VC transaction, control and governance provisions must be considered and addressed, such as the VC investor's level of board participation and its notice of, input in, and "veto rights" over important strategic, investment, financial, and even operating decisions. You can expect these considerations to result in the loss of some degree of control and operating flexibility (and a new regime of advance preparation, reporting, and accountability). Further, venture capital is structured as permanent capital stock (or equity interests); thus there is no unilateral means for the company to reverse a completed transaction or call the stock issued in the transaction. Finally, and importantly, VC investors—with negotiated control and liquidity rights in hand and a time horizon in mind—typically look to exit the investment over a three- to five-year period, which can result in a misalignment of interests with founders, managers, and other owners of common stock.

Choosing and Making the Most of a VC Partner

Raising much-needed capital from one or more VC firms is much more than simply effecting a financing transaction: it is the creation of an active partnership in which representatives of the VC firm typically become strategic consultants and advisors, and members of (and vocal voices on) the board of directors. Put simply, the VC firm—incentivized by its investment position and the need for investment returns—serves as a value-added partner, assisting and guiding the business in its governance, development, growth, and ultimate exit strategy.

Accordingly, in selecting this partner, capital-seeking business owners and managers should consider and evaluate a variety of factors, the importance of which will vary from venture to venture. This requires a pro-active effort, in combination with the advisory team, in advance of sending out executive summary business plans or seeking indications of interest from potential funding sources. Prior to selection, the company should research, question, and assess—and, once the funding is closed, should seek actively to take advantage of—some or all of these factors:

- How well the VC firm understands your business, market, and industry (which can be measured, in part, by the background and experience of its professionals, the thoughtfulness of the firm's questions and due diligence, and, of course, the quantity and comparability of the firm's other portfolio investments in your industry).
- The VC firm's level of interest and commitment to your transaction and company, and in a shared vision in the growth and development of the company.
- As to value-added partnering, the VC firm's (and the designated representative's) willingness and commitment to devote time, effort, and resources to the company.
- The quality, depth, and diversity of the VC firm's professional staff, consultants, and external services network, as well as its relevant industry contacts and perceived reputation; and the number and extent of other board commitments of the designated representatives should also be assessed.
- Good fit and chemistry with the designated representative, including your comfort in spending time with the representative; his/her intelligence, flexibility, responsiveness, openness, and honesty; and the representative's passion for contributing

to portfolio companies, level of required involvement in operational matters, and ability to function calmly in a crisis (remember, you will be spending a lot of time with this new partner).

- The VC firm's "patience" (*e.g.*, anticipated timeframe for achieving operational milestones and ultimate exit strategies) and record for dealing with portfolio companies that have experienced delays and difficulties along the way.
- The VC firm's ability, willingness, and expectation to provide or assist in securing capital in future funding rounds. (Note that a single capital raise may be insufficient to fund the company's entire business plan through break-even.)
- The ability of the VC firm to attract other venture capital and funding sources (including strategic investors and investment banks) to this and follow-on investment rounds. (Many venture capital investments are run by a lead VC firm, which then syndicates the investment with other VC firms.)
- The VC firm's views on the depth, coverage, and adequacy of your management team, and the VC investor's ability to assist in recruiting and retaining critical management personnel (including from its portfolio companies, relationships and contacts); also, the VC's views on fair compensation for the management team (you can and should expect a significant emphasis on incentive compensation designed to align the interests of managers and the VC firm in the business's eventual success).
- The valuation and specific investment terms, preferences, restrictions, and conditions the VC firm is imposing as a condition to its investment (including those relating to governance, control, and exits).

The advisory team—which should be deep with experience in the venture market and venture capital transactions—can provide invaluable insight and information regarding these and other matters of interest that will influence selection of one or more VC funds suitable to partner with (assuming that your company has the luxury of making a selection).

PRACTICAL TIP:

> The keys to improving your company's chances of successfully raising venture capital include: being uniquely and strongly positioned in a rapidly growing market; assembling a strong, cohesive management team; preparing a clear, concise business and execution plan; working with experienced advisors; and understanding potential investors' needs, objectives, and goals.

Venture Capital Fundamentals: Understanding Venture Capitalists and the Investment Process; Planning and Preparing for a VC Transaction

Entrepreneurs and emerging-business owners often ask: "What can I do to improve my chances of obtaining VC funding?" Five keys are outlined below, but most of it boils down to this: Make sure your business is advantageously positioned in a rapidly growing market; assemble a strong management team; prepare a clear, credible business plan and financial forecast; engage and consult well-respected and experienced advisors; and understand and anticipate the needs and goals of your potential investors.

1) Understand the business and goals of VC investors

Venture capital investing is serious business. VC funds are in the business of managing and investing funds to create exceptional internal rates of return (net of management fees) for their investors. The internal rate of return dictates the success and, in some cases, survival of the fund, now—in terms of satisfied investors—and in the future—in terms of attracting new and repeat investors to later, hopefully successive, funds raised by the VC firm. To attract real VC interest and attention, the capital-seeking business must convince the VC firm that a particular investment opportunity will exceed the firm's track record for return on invested capital: typically, a return of 30% to 50% or more per annum. (That is, the VC firm wants to make three to five times its investment or more, over its planned investment horizon.) For the VC firm to achieve this level of return, some investments must perform much better than average ("homeruns") to make up for the many expected unsuccessful or flat investments. In addition, given the limited lifespan of a VC fund (typically, 10 years), these internal rates of return must

be generated within a defined time horizon (typically, three to five years for any portfolio investment).

In a completed funding transaction, the VC investor will become an equity owner of the target business, typically holding preferred stock. The VC's initial percentage of ownership varies and depends upon a number of factors (principally, the amount invested and the pre-money valuation). Most venture funds, at least initially, do not desire an ownership position that exceeds 35% or 45%, largely because they want the existing owners and managers to keep substantial "skin in the game." The minority investment position also evidences a commitment to leave day-to-day management control in the hands of managers (with oversight by the VC).

Most VC funds seek to validate the investment prospect's market (and its place in that market) to ensure that the potential portfolio company is positioned in a market that can support the level of growth necessary to yield the VC's anticipated investment returns. Typically, the VC will look for a large, rapidly growing or relatively unstructured market, with no dominant or entrenched leaders and very little organized competition. These market dynamics offer an emerging company the potential to enter, grow, and sustain a strong position in the market. Thus, the capital-seeking business owner should analyze and define—as precisely as possible—the size and expected growth rate of the selected market, to forecast the company's opportunity within the market as well as the forces driving competition.

A word on *valuation:* VC firms are skilled valuation negotiators and are very focused on making investments at an appropriate, risk-adjusted, pre-money valuation. Many business owners view valuation as the all-important issue (since valuation drives the dilution in ownership that the founders and other owners will incur as a result of the VC investment). Yet valuation should be considered along with other issues, including those identified above,[2] as well as the specific features of the security to be issued and the terms and conditions of the investment transaction. Recognize that there are many risks attendant to an investment in an emerging private company and that valuation is not an exact science; it involves an inherently subjective process (notwithstanding that valuation negotiations may be based on tried-and-true methodologies).

2. See *Choosing and Making the Most of a VC Partner*, beginning on page 16.

Of course, for the deal to be done, both founders/owners and VCs will have to compromise and, at the same time, work to satisfy the other party's concerns and objectives. Maximization of returns and wealth creation are often best facilitated by an emphasis on the collective building of a strong, successful company, rather than on squeezing every last penny out of valuation negotiations. Many VC funding negotiations have failed as a result of irreconcilable differences of opinion on valuation.[3]

2) Understand the investment process—from initial contact through funding

Institutional VC firms look at hundreds, even thousands, of investment opportunities and business plans each year. In my experience, larger VC firms review, on average, between 1,500 and 2,000 plans and opportunities a year. Thus, the capital-seeking business owner must be mindful of the VC investment process—which, from initial contact to funding, typically takes three to five months and sometimes longer. Successfully obtaining funding requires that the owners (including founders) and managers survive the introduction, screening, meeting, due diligence, valuation, negotiation, documentation, and closing processes.

HOMEWORK AND INITIAL CONTACT—For the fund-seeking business owner, the process begins with homework: investigation and assessment of the potential VC audience in an effort to increase the likelihood of locating interested and appropriate investors. Owners will want to determine the current focus and bias of VC firms, if possible, because many VCs have preferences (their "sweet spot") based on the size of the investment, investment round, stage of development of the company, geographic location, market, and industry. You should also assess the VC's strengths, resources, reputation, value-adds, and prior portfolio investments. Because VCs receive so many business plans and investment opportunities, most look at, and devote more time and attention to reviewing, opportunities forwarded by gatekeepers—typically, a person who is known and respected by the VC (or its representatives or advisors), who has worked with the company and its management or who has subjected the business plan to some degree of pre-screening (*e.g.*, an

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3. Key behavioral drivers of VC investors are discussed in *Key Objectives of VC Investors—What Makes Venture Capitalists Tick?*, beginning on page 29.

attorney, accountant, banker, or consultant). Fund-seeking business owners (particularly those located outside Silicon Valley, New York City, and Boston) are well-advised to enlist, engage, and work with one or more of these gatekeepers in order to make the initial contact count.

SCREENING—Most of the opportunities submitted (85% or 90%) are screened out and eliminated after a very brief scan because they do not fit with the VC's objectives, criteria, and preferences, or because they were poorly thought out, prepared, or introduced. Most typically, companies are screened out because of their stage of development, location, management depth/experience, market or industry focus, market size, competitive dynamics, or amount of investment requested.

A CLOSER LOOK; INITIAL MEETINGS—Those that survive the initial screening process (10% to 15%) are subjected to some level of further review, which may include a full read of the business plan, financial information, and projections; preliminary inquiries and background checks with local network contacts and others; and telephone calls to respond to specific questions, and provide additional information. Less than half of this group (*i.e.*, around 5% of the total pool) will be presented with the opportunity to meet with principals of the lead VC firm (except, perhaps, for a friendly "happen to be in town, meet and greet" visit). If provided with this opportunity, the business owner should take it seriously, and be prepared. This is a milestone of sorts in the investment process. The VC will want to explore further the business plan, market, and prospects, and (more importantly) will seek to take measure of the owners and of the strength, character, and integrity of management.

DUE DILIGENCE; INITIAL VALUATION DISCUSSIONS—The fund-seeking company that has survived the screening, preliminary review, and initial meeting phases has made a significant accomplishment, given that less than 2% to 3% of the total pool will make it this far. The company will now undergo a greater level of scrutiny, usually preceded by the VC's delivery of a detailed due diligence request list, which covers meetings with key management and, perhaps, customers, suppliers, and other business relations; office/facility tours; competitive and market analyses; and a more intensive inquiry and review of business drivers, operations, management, and financial condition. The founders and owners should continue

their own due diligence on the VC firm (and the representatives who will be involved with this portfolio investment). You should also seek counsel to ensure—via an appropriate confidentiality or nondisclosure agreement, secure data room,[4] and information-exchange process—the proper management and protection of the confidentiality of the company's intellectual property, trade secrets, and sensitive information over the course of due diligence.

At this stage, the VC and the company will likely engage in discussions regarding the appropriate valuation for the business, predicated on the amount of funding in question, the financial forecasts provided by management, the VC's investigation to date, and the VC's internal financial model. The company's advance preparation of detailed, reasonable, and credible financial projections is critical. Expect due diligence inquiries and information exchanges, and the related consideration of valuation, to occur throughout the course of discussions and negotiations. The negotiated valuation—which VCs (self-servingly) often push for agreement on early in the process—will ultimately dictate the percentage of the company that the VC will receive and the founders, insiders, and managers will retain as a result of the agreed level of funding.

PRACTICAL TIP:

> Since the company may be providing information and materials to numerous parties, it is important to take appropriate steps—including a confidentiality agreement, a secure data room, and an agreed information-exchange process—to ensure that intellectual property, trade secrets, and sensitive information are managed and protected throughout the investment process.

4. A *secure data room* is a protected location where detailed, sensitive information is made available for review by interested parties. It can be actual (a physical location within the company's or counsel's offices) or electronic (known as a virtual data room, or VDR). The latter is a secure and dedicated website providing authorized users with limited or full electronic access to an online repository of due diligence documents relevant to a particular transaction. Documents are stored in an easy-to-read electronic format on a central server.

Throughout the due diligence process, which can be expected to take three to six weeks (but which does not end until the closing occurs), management should be in close contact with the VC firm in an effort to discern its interest and enthusiasm in moving forward. If indications are not favorable or if VC interest ceases, you should seek to ascertain how to avoid a similar result with other potential VC investors, by debriefing the departing VCs, for example, on the perceived weaknesses or flaws in the company, its management, its plan, or the process. Management should also seek the return of all previously provided confidential documents and information (a procedure for which should have been addressed in the confidentiality agreement).

TERM SHEET—If your company survives the due diligence phase and continues to attract the interest and enthusiasm of the VC firm after discussions of valuation and deal structure, you will be presented with a term sheet or letter of intent ("LOI"). The term sheet is offered to ensure that the parties are on the same page regarding the principal terms of the proposed investment. Once agreed upon, it will become the "marching orders" for the VC's counsel to prepare appropriate draft investment agreements and documents. In most cases, the parties (in particular, the company) are best served by a detailed term sheet that resolves as many important issues as is reasonably possible.[5]

The presentation of a preliminary term sheet can take place earlier in the process—depending on the style, cadence, and appetite of the VC, its comfort with the investment opportunity, and the amount of due diligence anticipated—as a reality check before proceeding with a significant (and expensive) due diligence effort.

The company should consult with counsel at the term sheet stage, because (i) the VC has a significant advantage (in terms of sophistication and experience in these matters), and thus the founders and owners are often in a disadvantageous position to appreciate the significance of, or to negotiate, important investment, governance, and other terms; and (ii) it may be difficult to renegotiate terms and conditions contained in the agreed term sheet when the draft definitive documents are served up by the VC's counsel. In addition, term sheets and LOIs (which, for the most part, are prepared as nonbinding indications of interest) may

5. An illustrative, annotated term sheet for a *Series A* preferred stock investment transaction is included as ANNEX A to this GUIDEBOOK.

contain certain binding and enforceable provisions, including a no-shop provision and clauses addressing access, confidentiality, and expenses.[6]

NEGOTIATIONS, DEFINITIVE AGREEMENTS, AND FUNDING—If your company survives the due diligence investigation and reaches agreement with the VC on a term sheet or LOI, absent a change in circumstances or market conditions, there is a reasonably good chance that you will proceed to signed definitive agreements *(i.e.*, the final purchase and investment agreements, embodying the legal terms and provisions relating to and governing the investment) and funding at a closing. The timing of this phase will depend upon the level of detail in the term sheet; the prior preparations, sophistication, and experience of the business owners and their counsel; the resolution of any critical pacing issues; the VC's approval process and other commitments at the time; and, of course, the absence of surprises or bumps in the road. Negotiations should be conducted in the spirit of (and embracing) the respect, fairness, and reasonableness in approach incident to embarking upon a long-term partnership, not merely a one-time financing. Absent any special closing conditions (*e.g.*, regulatory approvals or third-party consents), closing and funding may occur simultaneously with or shortly following the signing of definitive agreements.

3) Assemble and build a strong management (and advisory) team

It is said that the three most important attributes of any company seeking venture capital are "management, management, and management." The importance of management's depth, integrity, and competence (including its ability to execute the plan and deal with change) cannot be overstated.

Thus, senior managers will be an important, central focus of VC evaluation and due diligence. Depending on the company's stage of development, VCs will expect to see a management team with a strong track record; a proven skill set including substantial relevant

6. Under a no-shop provision, the VC receives the exclusive right (but not the obligation) to pursue, negotiate, and agree to the investment (via definitive agreements) for a defined period, often between 30 and 90 days. This provision should be carefully considered and reviewed with counsel.

experience (and success); honesty and integrity; completeness in depth and coverage; personal chemistry and the ability to work together (including under stressful and difficult conditions); the ability to work with new partners; and a strong understanding of the business, its markets, competition, and challenges, and the industry in which it operates. Each of the business's critical functions—*e.g.*, operations, finance, product design and development, production, compliance/quality control, sales and marketing—should be under the direction of an experienced manager who can stand on his or her own and can withstand the scrutiny of the VC's due diligence. And, of course, each member of the management team must have "bought into" the business's growth plan and milestones, the VC investment, and future plans.

Selecting, engaging, and working with respected, experienced outside advisors—counsel, accountants, consultants, and others—early and often in the process can be crucial to a fund-seeking business's success in starting off on the right foot, developing the business in a logical and proper fashion, and gaining the confidence of and funding from VCs and other sophisticated financing sources. Along the path of development, experienced advisors can add real value to the process of building the business's platform in a manner consistent with industry and market standards, and of preparing the company for the stringent due diligence and negotiation requirements of potential VC and other investors.

Advisors should have significant and relevant experience to be helpful in navigating the investment process, surviving and learning from various crises, seizing upon opportunities, and avoiding problem areas. They should be positioned (and willing) to use their contacts and make appropriate introductions (e.g., to potential management recruits, board members, technical consultants, strategic partners, funding sources, and other advisors). They can also be instrumental in providing some sense of credibility and an outsider's assessment and perspective of the company, its platform, investment prospects, and management team.

4) Present a clear, compelling opportunity via the business plan

The written business plan is the centerpiece for piquing the interest of potential venture capital investors. In fact, many VC and equity investors will not proceed unless a written business plan is available. Since VCs review many business plans each month, yours must "sing": it must present a compelling business and

investment opportunity; be current, clear and credible; and include what is commonly called a *teaser,* in which you boil the plan down to a concise, two- to five-page executive summary. The teaser is often used as the first information exchange with potential investors about your business and opportunity.

The business plan should address the components (or "drivers") that are key to plan execution, including:

- OVERVIEW—The company's business, products, services, and the market segment it is in (or plans to be in), with a clear discussion of all variables key to business success, such as technology, intellectual property, design, R&D, production, sales and marketing, distribution channels, customers, direct and indirect competition, etc.; include a clear statement of what distinguishes this business from current or future competitors.
- MANAGEMENT—Background, experience, relevant track record, commitment, motivation, and skills; what each member of management uniquely adds and what the team collectively brings to the company's plan and potential.
- HISTORY—Summary of the company's development to date, including key operational, management, financial, and other milestones contributing to its current value and future prospects.
- COMPETITIVE ADVANTAGE—Proprietary or differentiated products or services, intellectual property protection (strategy, stage, and execution), and technology dynamics; licensing arrangements, strategic relationships, and alliances; and anything else that creates a competitive advantage over other market entrants and participants.
- FINANCIAL STATEMENTS AND PROJECTIONS—Prior annual financial statements (best if audited) and financial projections for a three- to five-year period; must be discussed with advisors, scrubbed for reasonableness and credibility, and addressed in the overall presentation.
- CAPITALIZATION—Summary of the company's capital structure and capital (stock) ownership, including investors and investment capital received to date.
- RISKS AND OTHER CONSIDERATIONS—Frank and candid assessment of the problems, issues, and challenges that the business faces or will face in the future. (Every business faces challenges and

this discussion begins the process of building credibility with potential VC investors.)

There are many aspects and approaches to proper business plan preparation, updating, and dissemination, which are beyond the scope of this GUIDEBOOK. Care should be taken regarding confidential and sensitive information, and the formulation, review, and distribution of forward-looking statements, predictions, and any forecasted operating or financial information.

The VC firm is critically evaluating you, your team, and your business at every step in the process. The business plan (even if in draft form), the teaser, and all other forms of communication to potential investors serve as important touchstones for this evaluation as a potential investment prospect. They must be crafted to convey strong understanding, accuracy, confidence, consistency, and credibility. Accordingly, your business plan should not contain unrealistic projections, estimates, or assumptions, including on matters important to determining valuation. Remember, the VC fundraising effort can take many months and can experience many starts and stops; your previously provided business plan (drafts), budgets, and projections will live on, and you may have to explain later why you were unable to meet your expectations and forecasted results.

PRACTICAL TIP:

Venture capital investors will critically evaluate you, your team, and your business at every step in the process. The business plan (even if in draft form), teaser (executive summary), financial projections, due diligence responses, and all other forms of communication serve as important touchstones for this evaluation and thus must be crafted to convey strong understanding, accuracy, confidence, consistency, and credibility.

5. Be prepared—get and keep your house in order

VC firms, at various points in the process, will expect to perform rather extensive and ongoing due diligence on the subject company, its business, products/services, financial condition and prospects, operations, and management team. As fund fiduciaries, VC

fund professionals have a duty to analyze and understand the business, assets/liabilities, financial condition, prospects, strategy, market, industry, competition, risks, and—most importantly—how the investment is expected to generate exceptional investment returns over a defined time horizon. Each VC firm has its own approach, discipline, cadence, and routine for performing this function. The important lesson here: when the VC firm is ready to conduct due diligence (typically preceded by a detailed due diligence request list and following execution of a confidentiality agreement), the company must be ready to respond fully.

If the fund-seeking company is not prepared for this process, you should expect, at best, a delay in the process and questions regarding the seriousness and commitment of the owners and their team and, at worst, a sense that there is something amiss or a loss of interest altogether by the VC firm. By getting your corporate house in order and being prepared for intensive due diligence and the venture fundraising process in advance, you will be in a position to educate (and respond to critical questions posed by) potential investors and others, thus facilitating and perhaps even enhancing investment interest. Accordingly, any business owner seriously committed to the fundraising process must ensure that appropriate planning and preparation have been accomplished and should start early. This must be incorporated into the budget, as certain elements of the process will involve both management time and attention and the services and assistance of outside advisors, including counsel and accountants.

PRACTICAL TIP:

> Through sensible advance planning—and preparing for the questions, demands, and due diligence requirements of VC investors—you can distinguish your company from the pack. Making sure that your house is in order before you engage venture capitalists will demonstrate your seriousness and competence, and allow you to focus on the issues and challenges that undoubtedly will come up in the investment process. While being prepared will not guarantee successful funding, not being prepared will almost certainly ensure unfavorable consideration from the investor audience.

Key Objectives of VC Investors—What Makes Venture Capitalists Tick?

Just as a business manager must actively and continually seek to understand the wants and needs of target customers, so too should the fund-seeking business owner gain an appreciation of the goals and objectives of potential investors. Armed with a good understanding, owners and managers can save time, energy, and resources; plan for and anticipate the investors' needs; and more effectively consider, negotiate, and structure the investment transaction to meet the owners' goals.

There are four principal objectives that influence a VC firm's approach and behavior in the investment transaction process—objectives that owners and managers would be well-advised to consider in approaching, negotiating, and closing a venture capital investment. The due diligence process, the negotiations, and the structure, terms, and attributes of the investment[7] and investors' rights largely flow from and are dictated by the VC's treatment and implementation of these objectives (and the resolution of related issues):

- *Maximize the upside*
- *Protect the downside*
- *Monitor and influence the company's progress and development*
- *Assist with exit strategies and liquidity*

1) Maximizing the upside

RETURN ON INVESTMENT—Venture capital firms are typically organized as funds, with the management of the fund serving in a fiduciary capacity to the fund's limited partner investors (and with the managers typically also putting their own capital in play). VC funds seek deal flow in the form of investments in portfolio companies on an investment-by-investment basis, which can be sold or liquidated over a defined period at (hoped-for) exceptional rates of return. Put simply, VC funds are in the business of realizing a net return on investment (ROI) across their portfolio of investments, substantially higher than the return from alternatives limited partners could choose to invest in, including from competing venture

7. For a detailed discussion of structure, terms, and attributes commonly found in a VC investment transaction (and influenced by the VC's core objectives), see Section III of this GUIDEBOOK, beginning on page 45, as well as ANNEX A, an illustrative *Series A* investment transaction term sheet.

funds. These returns are necessary to justify the risks and indefinite periods of illiquidity inherent in investing in immature, high-growth private companies and to cover the firm's operating expenses and "override" incentive compensation. By achieving exceptional rates of return, VC funds ensure their survival and success in the cycle of fundraising, investment, input/oversight, and liquidity or harvesting of returns.

VC FUND'S DIRECTIVE AND INCENTIVES—VC funds are typically organized as limited partnerships: the management and investment professionals in the VC firm collectively serve as the fund's general partner, while the investors in the fund become limited partners. Limited partners typically contribute 99% of the capital in exchange for the right to 80% of the net profits (net of the general partner's annual management fee of 1.5% to 2.5% of the fund's assets, to cover salaries and other operating expenses).[8] The general partner's 20% override (also known as the "carry" or "carried interest") creates a powerful incentive to maximize the value of the fund's investments.

RIGHT SIZING—While owners and managers will have their own views as to the amount of outside investment capital required at a given stage of development, the VC will apply its independent analysis and perspective (as well as its fund requirements or protocols) to determine the appropriate amount of funding and capital resources the company needs to remove or significantly reduce risks, fund contingencies, and achieve short- and longer-term growth objectives. The VC will also address the issue of future access to capital and capital sources needed to implement the plan.

TIMING—As the saying goes, "timing is everything." In no area is this more true than in venture capital investing. The VC seeks to make its investment at the appropriate—and most opportune—stage in the company's life. In other words, not only must the VC's investment be made at the right time and thus at the right valuation, but the VC must also be convinced that the portfolio company will be able to achieve dynamic growth and take advantage of an available exit strategy over an investment horizon of three to five years by selling off some or all of its investment. Venture investors in early-stage companies may seek to time their investment, with the obligation to fund (at the initial agreed valuation) arising only if

8. The percentages, which reflect industry averages when this GUIDEBOOK was published, vary from fund to fund (and fund series to fund series).

certain agreed milestones or inflexion points are met. However, because milestones are difficult to gain agreement on (and define with certainty) and because most companies want all the funding to be provided at one closing, the vast majority of VC financings are "one-shot" deals, with the valuation appropriately reflecting future uncertainties.

PLAN AND PROJECTIONS—Venture capitalists must be able to chart and track the business's course through growth, developmental milestones, (improved) profitability, and exit. In order to do this, the VC must study and ultimately embrace the company's strategy, growth plan, products, and services; the market for such products and services; the company's market position; and its sustainable competitive advantages. Additionally, the VC, as part of its valuation process, must construct a detailed and reasonably justifiable set of projections, typically covering three to five years. The VC funding prospect may not make the cut because it is too early (or, sometimes, too late) to capture the optimal—or, at least, solid—period of growth in value. The VC's objective will be to invest in the company just prior to a significant increase in value, such as the company ramping up its business, revenues, or earnings through internal or external growth, or the successful achievement of competitive advantages or operational milestones.

MANAGEMENT: RIGHT PEOPLE AND RIGHT INCENTIVES—Most VCs speak and live the mantra that they do not invest in companies or products, they invest in people. After all, it is the people who make it all happen. A challenge for the VC is, consistent with its own objectives, to build an investment structure in which the VC supports and does not interfere with the proper functioning of management, and in which key managers are provided with financial upside and incentives aligned with the VC's interests. In other words, if the VC wins, management must win as well, and vice versa. The investment transaction will be structured to ensure that managers and certain owners have and keep "skin in the game." The alignment of incentives must be dynamic and flexible, continuing to work as the company grows, receives subsequent rounds of funding, and pursues and effects its exit strategies. Of course, the structure needs to accommodate management additions and departures, and the VC will want the ability to make management changes if that course best facilitates the growth and success of the business.[9]

9. See *Alignment of founder and management incentives,* beginning on page 53.

CUSTOMARY STRUCTURE AND DOCUMENTS—VC transactions have developed their own style and form, much of which has become rather customary. The documentation is extensive (and became somewhat more extensive and onerous following the "bubble burst" at the outset of the decade). Fund-seeking business owners interested in institutional VC financing must be willing to consider and work with what have become customary, VC-required structures, documents, and provisions, including: convertible preferred stock, with preferences, dividends, conversion features, and other superior economic rights; board membership; management oversight and reports; special governance (including consent and veto) rights; anti-dilution protection; preemptive purchase rights; and registration, co-sale, and other exit-related provisions. Through these and other mechanisms, the VC investor seeks to ensure that all of its key objectives—including that of maximizing the upside—are agreed to and implemented.

2) Protecting the downside

Given the substantial risk and illiquid nature of investments in high-growth private companies, no amount of attention to structure and terms, due diligence, or financial modeling can protect a VC from the occasional failure. In fact, the inherent risk of failure and the difficulty of achieving success in terms of return on investment is often what makes the investment attractive in the first instance. Nevertheless, certain structural provisions and protective terms can help to ensure maximum protection of the VC's capital investment in the company. These provisions help to protect the VC whether the company underperforms, goes sideways, or fails, and often operate at the expense of junior securityholders (*i.e.*, founders, managers, and all other common equity owners).

For the uninitiated, the documents served up by the VC's counsel may seem overly voluminous, onerous, and unfair. However, these documents and many of the structures and provisions they include have become rather customary for investments of this sort, and, in many cases, the company will have few (if any) other places to go for equity funding at this stage in its development. As well, business owners should recognize that, from an independent, outside perspective, the risk of non-performance or failure of the business—and thus the need for protection (particularly in view of the amount of capital placed at risk)—is very real. Experienced, deal-tested advisors can provide valuable insight in understanding the

complex weave of requirements and in negotiating terms to the owners' maximum advantage (or minimum acceptable disadvantage).

As an example (of a fundamental structural feature), the VC will structure its investment as a convertible preferred stock or equity interest (which will have unlimited upside coupled with priority on dividends and liquidation of assets to all common equity, plus other preferred rights that create a return superior to common equity); or in the form of debt or convertible debt (which will have priority on liquidation of assets to all equity securities and which can benefit from a number of contractual rights and restrictions). Additionally, the VC may seek to implement mechanisms to adjust, reset, or terminate incentive compensation structures, provide for forfeiture of unvested restricted stock, or provide special rights to the VC (and obligations of the company and other stockholders), if the company's fortunes turn substantially south of plan.

The VC will also likely seek protection in the form of a redemption or *put* right *(i.e.*, the right to require the company to repurchase the VC's shares) for a specified price, often with payment over a specified period. The redemption right would be operative if another route to liquidity has not been available or effected prior to a specified date (*e.g.*, five to seven years from the investment closing). The redemption right is rarely (if ever) exercised—among other reasons, because the company does not have sufficient funds or resources to repurchase the shares—but rather is intended to provide the VC with leverage to ensure that the company, prior to a specified date, actively pursues a path that results in liquidity for the VC, whether through sale, IPO, or otherwise.

Companies that experience disappointment or that go sideways often need additional capital to get back on track (or even survive), but find it difficult to attract such capital. *Pay-to-play provisions* (a form of downside protection among VC investors) have become increasingly common. These provisions provide an incentive for existing VC investors to invest in future down rounds *(i.e.*, typically, subsequent funding rounds at lower valuations). Investors that do not purchase their full *pro rata* share in a future down round can lose certain valuable rights *(e.g.,* they could lose anti-dilution protections or preemptive purchase rights, or their preferred shares could be converted into common shares).

3) Monitoring and influencing corporate progress and development

Before the investment transaction is completed, a detailed, transparent discussion will take place regarding the game plan and related timeline for the company's use of the investment proceeds, achievement of key milestones, organic and external growth, and ultimate liquidity or exit. The VC can be expected to impose discipline on this process, seeking to ensure regular and timely information exchanges, a reporting and budgeting process, and the proper monitoring of and input concerning the business's management, growth, and development (per the agreed game plan).

In addition, whenever a company proposes to add a new significant equity owner or partner, issues concerning governance (and control of the business's direction) must be addressed. In many cases, business owners will be concerned over who will "call the shots" in overseeing the direction and management of the business, and what say or control they will have, in good times and bad. The owners' (including founders') initial concern on the control issue (as presented by the VC investor) is often exaggerated and unwarranted. VCs, as a general rule, have no desire to run day-to-day operations; in addition, VCs do not have the managerial personnel or the technical expertise to manage and run numerous portfolio companies of varying sizes and maturity and in diverse industries.

On the other hand, VCs will insist on being kept informed on the big-picture issues. For example, the VC will expect to be advised, regularly and systematically, regarding the business, growth, competitive position, financial condition, results of operations, and capital resources of the company. Additionally, the VC will want to ensure that the company stays on or ahead of the agreed game plan and will expect to be apprised of variances from the budget/plan and involved in establishing the budget/plan for each ensuing year. The VC will also expect to have a voice in, if not control (or veto rights) over, the company's pursuit of future financing and exit transactions. To the delight of many VC-backed companies, venture capitalists often prove to be valuable partners, bringing both financial and non-financial expertise, experience, contacts, and proven success to and for the benefit of the company.

a) The governance vehicle: the investor rights agreement

In most VC transactions, the parties will enter into an *investor rights agreement*, which is the centerpiece for control, corporate governance, securities transfers, and other issues. The issues typically addressed in the agreement include board composition; management positions; restrictions on share transfer; preemptive purchase, co-sale, *tag-along*, and *drag-along* rights; *call* and *put* options; veto and supermajority vote requirements; and certain performance incentives.[10]

BOARD OF DIRECTORS—For the uninitiated entrepreneur or business owner, the board of directors of the company becomes far more than a formality once a VC or other sophisticated outside investor comes into the picture. The board oversees and dictates the direction of the company; hires, supervises, and compensates senior management (and sets incentive bonus targets); ensures that appropriate controls are in place; reviews and approves significant contracts, financings, capital commitments, and acquisitions; reviews detailed periodic, sometimes monthly, information and reports; reviews and approves the annual budget and plan; and ensures the company is staying on plan.

Accordingly, in connection with a planned investment transaction, the company will need to address several issues relating to the board of directors, including:

- the board's composition
- the number of members the VC will be entitled to designate and elect
- the number of members the founders (and existing owners) will be entitled to designate and elect
- the matters that will require board approval
- the precise level of approval required for any specific matter (and whether, for example, approval by one or more VC-designated board members will be required)

10. In some VC transactions, a separate *co-sale (and first refusal) agreement* covers a number of these terms. The use of separate agreements is a function of VC style (and local custom), the parties to the agreements (which can vary), and distinct remedial and other provisions. See ANNEX A to this GUIDEBOOK (an illustrative *Series A* investment transaction term sheet) for a listing and description of various terms and provisions often included in investor rights and co-sale agreements.

- the ability of non-board members to receive board-level notices, information, and reports

In situations in which majority appointment rights are an issue, a frequent compromise is to provide for one or more independent directors, designated by the VC yet acceptable to the founders (and existing owners), to hold the swing board seat. Typically, if less than a specified threshold (*e.g.*, 10% or 25%) of the preferred shares originally issued to investors remains outstanding, the investors lose their special board designation rights and veto rights and simply have the right to vote for directors along with the common stockholders, on an as-converted basis.

In addition, VCs usually seek some level of control over the selection, addition, and termination of key managers. It is not unusual for a VC, particularly in seed and early-stage investments, to require that certain management positions—including the CEO, CFO, and CTO—be filled with persons satisfactory to the VC. The terms of these officers' employment agreements typically must be reasonably satisfactory to the VC.

TRANSFER RIGHTS/RESTRICTIONS—The investor rights agreement (or co-sale agreement) usually contains provisions restricting common stockholders from transferring their shares (subject to customary and negotiated exceptions), as well as preemptive purchase rights that permit the VC investor to maintain its percentage ownership interest in the event the company issues or sells additional equity securities. In addition, the VC may also seek a co-sale (*come-along* or *tag-along*) right, which permits the investor to sell a portion of its shares if a founder or another common stock owner subject to the right sells his or her shares. This right is designed to protect investors from being left behind when the founder attempts to cash out. The company can often negotiate various exceptions to the co-sale right.

VC investors may also request *drag-along rights:* the right to require the founder and other stockholders to sell their shares (along with the VC) if the investor approves and participates in a sale or other change-of-control transaction. The drag-along right facilitates the VC's exit strategy and prevents "holdouts" from blocking a sale of the company where the buyer is only interested in buying 100% stock (or equity) ownership. Care should be exercised in agreeing to drag-along rights, particularly in cases where the VC investor has negotiated special (*e.g.*, participating preferred)

economic rights and thus where requiring common holders to "go along" with a VC-approved transaction may not be in such holders' best interests.

In a few situations, the VC or the company may seek a *call* or *put* option, which allows the company to purchase (or a stockholder to require the company to purchase) all or a portion of a stockholder's shares, on specified prices and terms, upon the occurrence or non-occurrence of certain milestones or events.

VETO RIGHTS AND SUPERMAJORITY VOTES—Sometimes the investors who constitute a minority of the total voting power (on an as-converted basis) may seek to require a class vote, a greater-than-majority stockholder vote, or other special voting or *veto rights*[11] regarding the approval of certain significant corporate actions and matters. Actions by the company over which VC investors typically seek to require such veto or blocking voting rights include:

- a sale or other change in control or dissolution of the company
- authorizing or issuing new securities on parity with or senior to the investor's securities
- changing any provision of the company's charter or organizational documents in a way that adversely affects the rights of the preferred securities owned by the investor
- paying dividends on any capital stock
- entering into any new line of business
- redeeming or purchasing any company securities (other than upon conversion of the preferred securities or pursuant to the investor rights agreement)

Some VC investors, particularly in recent times, have a somewhat longer list of corporate actions over which they require veto or blocking voting rights, including:

- changing the nature of the company's business
- incurring debt or making capital expenditures exceeding a specified dollar amount
- entering into any contract or commitment that obligates the company to spend in excess of a specified dollar amount
- entering into any contract or commitment that obligates the company to acquire stock or assets with a value over a specified dollar amount

11. These rights are usually sought at both the securityholder and the board of directors levels.

- increasing the number of options reserved for issuance under the employee option plan

PERFORMANCE INCENTIVE MECHANISMS ("VC TRAFFIC SIGNALS")—To promote an alignment of interests, most VCs will seek to incorporate a variety of performance incentive mechanisms (which I refer to as the "VC Traffic Signals")—with designated rights, obligations, and consequences—related to whether the business is proceeding according to plan. The VC may request that these mechanisms be placed in the investor rights agreement or other plans or agreements to encourage the achievement of plan and to attach adverse and onerous consequences (including special rights of the VC) to a failure to do so. The number, scope, and variety of these concepts and provisions are limited only by the creativity and concurrence of the parties and their counsel.

The traffic signals—and their implications—are as follows:

- *GREEN LIGHT.* If all is going reasonably according to, or better than, plan, then no adverse consequences or special rights or obligations ensue. Information is freely shared between the company and the VC, whose participation takes place through board representation and interim reports and updates. In such a case, all incentives and related arrangements are on track (per board-approved targets).
- *YELLOW LIGHT.* Here, the company is experiencing some deficiency, disappointment, or significant delay regarding the achievement of one or more important milestones, such that it is performing, or can reasonably be expected to perform, below (or behind) plan. In such a case, through structural mechanisms and restrictive terms (and the application of pressure from the VC firm), a number of consequences are possible: (i) the VC may get an enhanced opportunity to receive and scrutinize information; (ii) the VC may get a greater decision-making voice (through enhanced board or management participation or veto requirements); (iii) founders and managers may lose some voice, vote, or rights on certain important matters; and (iv) founders and managers may lose or experience some delay or reduction in their financial upside.[12]

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12. By not hitting agreed targets, management (and founders) could lose bonuses or other upside-based incentive compensation, or miss vesting conditions on restricted stock or options, or be subject to dilution, or see targets and related rewards subject to reset.

- RED LIGHT. The VC will require even more if a serious issue arises that makes it virtually impossible to achieve plan on a timely basis. In such a case, several consequences are possible: (i) the VC might exercise complete control over the board or the direction and management of the company; (ii) owners and managers may lose various rights and all financial upside, be subject to termination, or be subject to dilution and loss of rights (and, in the case of founders, loss of unvested restricted stock); and (iii) the VC may have the right to liquidate the company, be bought out, or force a major restructuring transaction.

Some founders (and existing owners) have sought their own forms of rights and protections, in the event the company performs substantially over (or ahead of) plan. You might call this a *super green light* scenario. In the case of such an "over-perform," founders (and owners) may seek provisions that either or both (i) vest incentive compensation awards (and, if applicable, founders' shares subject to vesting); and/or (ii) strip away certain rights otherwise afforded to VC investors (*e.g.,* if certain financial milestones are met, preferred participation rights can be lost or limited, and certain veto voting rights may be lost as well).

b) Employment agreements for founders

In most cases, the capital-seeking business is substantially dependent on one or more key members of management, who may be founders or early-stage owners and whose loss would clearly be detrimental to the company. The founders, naturally, have an interest in clearly defining, structuring, and protecting their participation in the business's governance and management as well as their continued role, position, employment, and compensation following the VC investment. VCs, however, typically disfavor full-blown employment agreements with founders and managers (other than the CEO). The VCs do, however, look for agreements that require confidentiality and assignment of inventions and that restrict post-employment competition and employee solicitation activities.

When employment agreements with founders are negotiated, you should expect to address these issues:

- compensation (including salary and bonus), benefits, and term of employment
- employee's title, role, reporting line, and responsibilities (and when these can be changed)

- the circumstances under which the employee may be terminated or leave employment (often negotiated as "for cause" or "for good reason")
- payments and benefits, if any, due upon severance (including death and disability) and termination
- the company's right to purchase the employee's stock (what amount of stock, in what events, at what price, etc.) following severance or termination
- the employee's participation in the company's option or incentive compensation plan
- restrictions on post-employment competition and employee solicitation activities

4) Assisting with exit strategies and liquidity

As noted above, VC firms are in the business of working to create exceptional internal rates of return on the capital invested in their funds. These returns are created, and are only realized, when some measure of liquidity—the ability to sell for cash—attaches to the securities the VC received in return for its investment in a portfolio company. Liquidity, in turn, is the function of the company availing itself (typically, with the VC's guidance and input) of one or more exit strategies.

a) Classic friendly exits

INITIAL PUBLIC OFFERING—An initial public offering (IPO) is the first underwritten public offer and sale of a specified number of shares of the company's common stock. The company, through a syndicate of underwriters, issues and sells additional shares of its common stock to public stockholders for cash. This highly regulated process typically results in the shares being listed or quoted on a recognized exchange and a free-trading market for these shares. It also results in various stringent disclosure and other obligations of the company and its officers, directors, and affiliates. Depending on market conditions and other factors (such as negotiated rights), shares owned by founders, managers, and the VC may also be registered and sold in the IPO, but typically such sales are limited.

Registration rights or other contractual provisions are designed to permit the VC to control or influence the share registration process, and to permit the sale of its investment interest first, before founders and other insiders. Once the company has completed its IPO and thus has "gone public," the VC may also achieve its

desired liquidity (after a *lock-up period* required by the underwriters) through open market sales. These sales must be made in compliance with Rule 144 under the federal securities laws or through a secondary (or *follow-on)* registered public offering of securities, with the "pecking order" and other terms for sales in such offering established through the agreed registration rights.[13]

Of course, the ability to consummate an IPO depends upon many factors (beyond the proper focus of this GUIDEBOOK), not the least of which is the relative health, depth, and receptiveness of the stock market and, in particular, the market for new issues (by companies in industries comparable to yours)—in terms of industry, size, maturity, and other dynamics—at the time the IPO registration process is completed. In addition, companies contemplating an IPO must consider (and should obtain expert advice regarding) the regulatory regime to which public companies, their directors, officers, and insiders are subject. Sweeping changes in the regulatory landscape have resulted from the Sarbanes-Oxley Act, SEC rulemaking, and related changes in Nasdaq and other stock exchange rules and listing standards. Companies contemplating going public must be mindful of the increased importance of careful advance planning and preparation.[14]

PRACTICAL TIP:

Given the regulatory climate, planning and preparation has increased in importance. Exit- and liquidity-related rights and obligations will be negotiated and embraced in the VC investment agreements. Long before an IPO, cultivate relationships with investment bankers; obtain compliant audited financial statements (and ensure auditor independence); establish and document internal controls and procedures; address insider arrangements and transactions; build a proper board of directors; and attend to corporate governance issues.

13. For further discussion regarding registration rights commonly addressed in VC transactions, see *Registration rights,* beginning on page 51, as well as ANNEX A, an illustrative *Series A* investment transaction term sheet.
14. See *Going Public—The IPO,* beginning on page 11, and the resource materials referenced therein.

Some periods have been more IPO-friendly than others. The late 1980s and 1990s, for example, were characterized by an active IPO market particularly receptive to VC-backed companies. Since 2000, however, the IPO market has been challenged (to say the least), fickle, and less receptive. There are signs that the IPO market is rebounding and may soon become more welcoming to a wide variety of emerging and growing businesses; nevertheless, with IPOs more difficult to accomplish and less predictable and reliable as an achievable exit, other exit strategies—particularly the outright sale of the company—have become far more prevalent. Note that selling to a strategic, public buyer, where the consideration is the buyer's publicly traded shares, is another means, in effect, of taking your company public (since your stockholders end up owning a public, marketable security). A word of caution, however: mergers with public shell companies should be studied and undertaken with great caution, and be sure to use experienced counsel.

Remember, VCs are in the business of generating superior returns for their investors—returns that may be achieved only by converting the VC's investments in its portfolio companies into cash or marketable securities. The VC's expectations regarding the likely exit strategy will clearly impact how the investment transaction and related investor rights and owner/company obligations are structured, as well as the plan and course of the company's growth and development.

SALE OF THE COMPANY—The prevailing exit strategy of choice is the outright sale of the company. Whether by merger, sale of stock, sale of assets, or other transaction (including a leveraged buyout by a private equity fund), this exit strategy has clearly overtaken the IPO as the preferred route to liquidity. A sale of the company has several significant advantages over an IPO, including: time to and certainty of liquidity (particularly in a broad, deep, active M&A market); possible superior valuation (again, in a favorable M&A market, there may be a change-in-control premium not available in an IPO); extent of liquidity (*i.e.*, the ability to sell the entire position vs. obtaining some measure of liquidity in or after an IPO); less dependence on stock market conditions; and the potential liability exposure incident to an IPO.

Given these advantages and the difficulty, expense, and uncertainty surrounding an IPO, most VCs are—starting shortly after closing—pursuing the strategy of developing the corporate platform, improving the management team, ramping up performance,

and achieving other milestones in contemplation of the company's sale. Accordingly, the game plan will incorporate these milestones (and management's incentive compensation may, in some measure, be dependent on achieving them). Control over the decision to sell the company (and possible *drag-along rights)* will be key. You can expect the VC investor to require a say in, if not control over or veto rights on, this decision. Since the final go-ahead for an outright sale usually requires the approval of both the board and the security-holders, the process and the governance issues at both levels are important and should be addressed at the outset.

Capital-seeking companies must remember at all phases of development (but particularly during the early stages) that much of the attraction in a sale—that is, what buyers are interested in acquiring and paying a premium for—is the dedication, commitment, focus, and creativity of the management team and key employees. As a result, you should consider and craft the stock ownership, incentive compensation, and employment (including bonus) plans and arrangements well in advance of a transaction, to ensure the continued dedication and employment of key personnel. Otherwise, the business will likely be unsellable or certainly much less attractive (and thus less valuable).

PRACTICAL TIP:

Given the current state of our markets (regarding exit transactions), most VCs are—from shortly after the investment closing—pursuing the strategy of developing the corporate platform, improving the management team, ramping up performance, and achieving other milestones, all in contemplation of a sale transaction (and the likely demands of potential buyers).

b) Other exits

The most successful and common exit avenues have been discussed above. Of course, a VC could also sell all or part of its investment in the company to another VC, private equity fund, or other third party. This does not happen often and may be a sign of trouble. Partial liquidity can be gained through a recapitalization,

follow-on investments, dividends, and stock repurchases, but these are not usually preferred exits.

Put simply, if the company's sale or public offering cannot be accomplished within the planned time horizon (plus some reasonable extension), then the VC's liquidity options are limited. And remember, given its preferred position and the other attributes of its investment, if the VC's position is not good, the position of the owners, managers, and other insiders will usually be worse. This scenario triggers a new, often complex and troublesome, phase for the business and its owners: regroup and reset expectations, reconfiguring, (possibly) new capital and investors, and execution challenges.

SECTION III:

What to Expect in a VC Transaction: Key Terms, Features, and Attributes

While the very concept of a venture investment can be intimidating enough for the uninitiated, the structure, terms, attributes, and documentation of a VC transaction and the related rights, restrictions, and protections can be mind-numbing. These matters in many cases defy any notion of common or business sense, pointing to the obvious need for advisors with extensive and relevant experience in transactions of this sort. It is important for any serious candidate for or prospective recipient of VC funding to become familiar with the structure and features of a typical VC investment.[1]

Forms of Investment and Related Provisions

1) Equity and related protective provisions

CONVERTIBLE PREFERRED STOCK—Clearly the accepted medium of VC investing, *convertible preferred stock* is the most common form of equity security issued in a VC transaction. This form of preferred stock provides the VC with a preference on dividends, distributions, and liquidation over common stock and, in most cases, over other (junior) series of preferred stock, yet it has all the upside potential of common stock because it is convertible into common stock. It also presents important tax and valuation advantages to

1. In addition to the text that follows, see ANNEX A to this GUIDEBOOK, which is an illustrative *Series A* investment transaction term sheet. It includes a detailed listing and description of the various terms, features, and provisions commonly included in a VC term sheet involving a *Series A* preferred stock financing round.

the VC investor. For example, the special and preferential features of preferred stock permit a discounted valuation of common stock, including for stock option and equity-based grants and awards; among early-stage companies, discounted pricing of one-third to one-fifth of the preferred stock's price is not unusual for common shares. Additionally, convertible preferred stock is designed to ensure that the VC or other preferred investor has the right to get its cash back—plus (often) a fixed dividend or return on investment—before the holders of common stock (*i.e.*, founders, executives, and other insiders).

(FULL) PARTICIPATING PREFERRED STOCK—Generally, in the event of a merger, sale, or liquidation (including any agreed *deemed liquidation* events), the preferred stockholders first and as a priority receive an amount equal to the original purchase price (the *liquidation preference*) plus accrued and unpaid dividends before the founders, executives, and other common stockholders get a cent. *Participating preferred stock* entitles the holder not only to receive the stated liquidation preference, but also to receive a *pro rata* share (assuming conversion of its shares into common stock) of any remaining proceeds available for distribution to common stockholders. Typically, preferred stock is not participating (but the matter is subject to negotiation, including capping or limiting any participation rights).

Where participating preferred stock is used, the common stockholders may be disappointed when a triggering transaction occurs. They may then realize that giving the VC investor the "first bite" (by payment of the liquidation preference) results in a substantially lower per-share price and proceeds available for distribution to the holders of common stock (which includes the VC investor's shares on an as-converted basis). Moreover, this provision can result in a divergence of interests upon sale and change-of-control transactions at certain transaction-value levels, including in instances where the VC investors favor the transaction (because of their participating preferred payout) while the founders, owners, and managers oppose it. Companies (founders and existing stockholders) should strongly resist this form of preferred stock or attempt to limit its application or effect by, for example, insisting on a cap on the participation right or providing that the right will not apply if the VC investors have made at least some agreed-upon return on their investment.

LIQUIDATION PREFERENCE—This is the amount, fixed in the preferred stock instrument, that the holder of preferred stock is entitled to be paid, upon a sale, liquidation (including deemed liquidation), or dissolution of the company or upon redemption of the preferred stock, in advance of and with priority over any payment or distribution to the holders of common stock or junior preferred stock. Normally, the liquidation preference is fixed at the original purchase price (on a per-share basis) paid at the closing of the investment transaction. VCs have been known to request (and, in some circumstances, have obtained) *super* or *multiple liquidation preferences* on their preferred shares. Such a provision provides the holder of preferred stock with the right to receive more than the purchase price back before the balance (if any) of the sale or liquidation proceeds is distributed to the other stockholders.

CONVERSION AND AUTOMATIC CONVERSION FEATURES—Convertible preferred stock provides the holder with the right (but not the obligation) to convert its shares to common stock, at any time and in the holder's discretion, at a specified conversion ratio. In order to clean up and simplify the company's capital structure at the IPO stage, convertible preferred stock typically provides for automatic conversion into common stock upon a *qualified IPO* (sometimes referred to as a "QPO").[2] The terms of the preferred stock may also require automatic conversion when (i) less than a specified percentage of the preferred shares issued in the financing round remains outstanding; (ii) the conversion is approved by more than a specified percentage of the preferred shares in a financing round; or (iii) a *qualified sale* transaction[3] is consummated.

DIVIDEND FEATURES/ACCRUING DIVIDENDS—Preferred stocks often provide for a dividend (of 4% to 9%), which must be paid before any dividend may be declared or paid on the common stock or junior preferred stock, thus giving a priority yield to the preferred stock. In almost all investments in early-stage and emerging companies, however, dividends on preferred stocks are not current and, in

2. A *qualified IPO* is usually defined as a firm-commitment underwritten initial public offering of a specified size and price, expressed in terms of minimum gross proceeds and/or a minimum share price as a multiple of the investor's original purchase price.
3. A *qualified sale* is usually defined as a sale or change-in-control transaction in which the per-share purchase price exceeds certain agreed return-on-investment parameters.

most cases, are not cumulative—meaning that dividends do not accrue from year to year until paid.

In some financings, VC investors require that dividends accrue and cumulate, whether or not declared by the board. In such cases, companies will want all previously accrued but unpaid dividends to be waived and forfeited upon any conversion of the preferred stock into common stock, for example, prior to an IPO, QPO, liquidation, or qualified sale transaction. If the parties agree to an *accruing dividend,* then the unpaid dividends would become due and payable upon liquidation or redemption of the preferred stock. Since a sale of the company is typically deemed to be a liquidation event, the accrued dividend effectively increases the liquidation preference of the VC's preferred stock interest.

ANTI-DILUTION PROVISIONS—These provisions afford preferred stock investors protection against dilution of their investment interest (*e.g.*, conversion rights, liquidation preferences, and other economic rights), principally in the event of future transactions or financing rounds involving the issuance of equity securities or rights, warrants, or options to purchase, or securities convertible into or exchangeable for, such securities. Dilutive issuances in future *down-round* financings[4] are of particular concern to VC investors, because they may indicate that the agreed valuation in the prior investment round in which the VC participated was inflated or overvalued.

A *full-ratchet anti-dilution provision* is most favorable to VC investors; it provides that the conversion price of the preferred shares is reduced to the price paid in the dilutive issuance, regardless of how many shares are issued in the dilutive issuance. By contrast, *weighted-average anti-dilution provisions* (whether broad-based or narrow-based) provide for more balanced protection, since they take into account the dilutive impact of the issuance in question based on such factors as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after such issuance.

PAY-TO-PLAY PROVISIONS—*Pay-to-play* provisions, a form of downside protection among and between the VC investor group, are

4. A *down round* is a subsequent financing round in which securities are issued and sold at a lower valuation (on a common stock equivalent basis).

becoming increasingly common. These provisions provide an incentive to invest in future down-round financings, as well as a thorny disincentive for not participating: investors that do not purchase their full *pro rata* share in the future down round lose certain valuable rights (for example, they lose anti-dilution protection, super-liquidation preferences, and/or preemptive purchase rights, or their preferred shares convert into common shares).

COMMON STOCK—The ultimate vehicle for equity upside in a corporation—*common stock*—could also be used for a VC investment. More likely, common stock (coupled with certain investor rights) would be used in an *angel* financing round. As discussed above, *convertible preferred stock* has all of the advantages of common stock plus certain preferences and other advantageous features.[5]

WARRANTS—A *warrant* is the right to purchase a specified number of shares of common (or preferred) stock at a fixed price and during a specified time period. In certain situations (as part of the valuation discussion), warrant coverage is granted to the investors, typically as a deal sweetener: the VC investors receive a warrant to purchase an additional number of shares at the investment price in addition to the shares of stock that they purchase in the transaction. Warrants may also be utilized to reward lenders for the risk of making a bridge loan, with the number of shares subject to the warrant typically based on a percentage of the loan's principal amount.

2) Debt only

It is extremely rare for a VC transaction to be structured as a debt-only investment, with one exception. In some circumstances, the VC will provide a *bridge loan*, used to fund operations while the investors conduct due diligence, negotiate the definitive terms of the investment, or proceed with other preliminary matters prior to closing. Such a bridge loan is usually convertible into equity, on an agreed basis, at the company's next completed equity financing.

3) Mix of equity and debt

In some circumstances, the VC will structure its investment using both stock (common or preferred, with or without warrants)

5. See discussion of *Angel Investing*, beginning on page 56; and *Convertible Preferred Stock*, beginning on page 45.

and debt (senior or subordinated), or by using convertible notes or debentures, or debt with warrants.

Other Mechanisms to Achieve or Assure Financial Upside

1) Equity ownership and liquidity considerations

a) Valuation issues

The agreed valuation, together with the amount of the investment, drives the determination of the percentage of equity securities—and thus ownership—that the VC will receive (and that the founders, managers, and other owners will retain) at the closing of the investment transaction.

- *Pre-money valuation* is the theoretical value of the company before the VC funding is received. It is calculated by multiplying the number of outstanding, fully diluted shares of the company before the investment, times the purchase price per share in the investment transaction.
- *Post-money valuation* is the pre-money valuation plus the amount of funds invested in the transaction.

The VC investor, of course, focuses the business owner's attention on the pre-money value (and the difference in the pre- and post-money values). All parties need to consider and plan for an appropriate *option pool* to attract, incentivize, and retain management and key employees, as well as the effect of the option pool shares on valuation, dilution, and important deal provisions. The valuation of private companies and their securities is a subjective exercise—more art than science—and it depends more on negotiating leverage, market factors, and the need for funding (and available funding options) than on traditional valuation methodologies.

b) First refusal and preemptive purchase rights

Many VC investors request *preemptive purchase rights*, which are rights to purchase stock in future offerings by the company on the same price and terms as offered to other purchasers. The purpose of the preemptive purchase right is to enable the VC investor to maintain its percentage ownership in the company. The VC investor may also ask for a right of first refusal, which is a right to purchase the shares of a selling stockholder, usually the founders and other significant existing owners, before those shares can be sold to a third party. The right of first refusal helps to ensure the planned

and orderly transfer of founders' shares. Various exceptions to these rights are commonly negotiated. Founders and significant stockholders may also request these rights.

c) Staged, milestone-based funding

Where the VC investor has identified specific objectives the company needs to achieve over a short time period (in order for the company to achieve its agreed valuation), the investor may seek to invest its funds in stages or tranches, such that a portion of its committed funding would be invested only if the agreed milestones are met. Milestone-based funding provisions can be complicated and give rise to numerous issues—*e.g.,* precisely defining and measuring each milestone, providing agreeable cure periods, and specifying the remedy in the event an obligated investor fails to fund when required.

d) Registration rights

The VC will seek (and, in most cases, insist on) the right to require the company to include, in a registration statement, shares owned by the VC—in priority to shares held by other stockholders—and, more generally, the right to control the registration of shares by the company.[6] There are three types of so-called *registration rights:*

DEMAND RIGHTS—A *demand right* allows the investor to require the company to register a specified number or percentage of the investors' shares in a public securities offering, even if the company was not otherwise planning to conduct such an offering. Usually, the demand right must be requested by the holders of a specified number of shares, with the demand right applying to some percentage of the common shares issuable upon conversion of the preferred shares. Typically, this right is not operative until after the company's initial public offering, is limited to one or two registrations, and is subject to exceptions. For example, the managing underwriter may have the discretion to cut back the number of shares included in the registration,[7] or the company may not be required

6. A registration statement is filed by the company with the SEC to register company shares (under applicable federal securities laws) in connection with a public offering of these shares.
7. See *Piggyback Rights,* on page 52, for further discussion of cutback rights.

to register shares if SEC Rule 144 or a comparable rule is available to permit market sales of the shares.

S-3 REGISTRATION RIGHT—An *S-3 registration right* allows the investor to require the company, once it is eligible, to register a specified number or percentage of the investors' shares under a short-form registration statement on Form S-3 (assuming the company is eligible to use such form) if at least a specified minimum number or percentage of the holders request it. Typically, the company is only required to register the shares if the minimum aggregate offering price exceeds a specified level (*e.g.*, $1 million to $3 million), and the parties will negotiate who bears the expenses of registration. An S-3 registration right is like a demand right, but less burdensome and expensive to the company because of the availability of the S-3 short form.

PIGGYBACK RIGHTS—A *piggyback registration right* allows the investor to have its shares included in a public offering that the company is conducting for itself or other stockholders. Piggyback registration rights are always subject to *cutback rights,* which provide a means for determining whose shares are included in the offering and whose may be excluded (or cut back), when there are too many shares for the underwriters to sell in the offering. The decision as to how many shares to sell is based on market conditions and, ultimately, the judgment of the managing underwriter. The company usually seeks to provide that piggyback rights are not available if SEC Rule 144 or a comparable rule is available to permit market sales of the shares. Investors often request that cutbacks be effectuated first against founders and other insiders before reducing the investors' shares.

e) Other registration concerns

COSTS AND CONSENTS—The parties must decide who bears the costs of any registration occurring pursuant to registration rights, as well as what registration rights may be provided to investors in future rounds and what approvals or consents of existing investors may be required. It is not unusual to see a provision that requires the consent of a majority of the holders of demand registration rights before further registration rights may be granted.

INFORMATION RIGHTS—Investors typically require that, until such time as the company has gone public or less than some specified percentage of the preferred stock issued in the round remains out-

standing, the company will provide the investor with annual audited and quarterly unaudited financial statements and, in certain cases, annual budgets, monthly financial statements, or other specified information.

2) Alignment of founder and management incentives

The VC will want to ensure that the interests of the founders, managers, and key employees, as well as the compensation of all significant personnel, are aligned with the VC's interests in maximizing the value of its investment and timely pursuing available exit strategies. There are several mechanisms to consider.

a) Initial position and vesting

As a starting point, the VC will want the founders, managers, and key employees to have sufficient "skin in the game" to motivate performance and thus maximization of the value of the business. VCs look favorably upon founders and managers who have invested in themselves and are prepared to stay the course and to share in the risk of possible failure. Venture investors have been known to request, particularly in early-stage ventures, that the founders' shares vest (*i.e.*, when they become "earned" and nonforfeitable) only in stages and only after continued employment with the company or the passage of time. The number of shares deemed already vested and the vesting schedule for the balance of the shares are both subject to negotiation, but the parties should take care to keep significant equity incentives in place, on a continuing basis, to provide for the business's future growth and funding and to pursue and effect exit strategies. The VC also may request limitations on the ability of founders and managers to sell their shares over a defined period, prior to an IPO or sale of the company.

b) Equity-based compensation plans, grants, and agreements

Companies are increasingly adopting broader and more flexible incentive compensation plans. Properly crafting management (and key employee) compensation and incentives requires focus and discipline and involves a complex, dynamic, ongoing process. The investors will require assurances on, among other things, the maximum size of the option pool and a normal vesting schedule, which will play a role in valuation discussions.

The challenge is to craft financial rewards and incentives aligned with the budget, projections, and milestones, on which both management and the investor have signed off and which are competitive in attracting and keeping key management personnel. The fund-seeking business should consider and adopt an appropriate form of written incentive compensation plan to provide flexibility in granting these incentives while, at the same time, ensuring that intended tax and accounting benefits are maintained and not lost.

The stock option plan is the most basic and most commonly utilized equity-based compensation plan. In setting up a stock option plan, the company will need to consider who is to be included initially and at what level. Additionally, the company will need to determine the number of shares in the aggregate to be included in the option pool (typically, 12% to 20% of the fully diluted shares), the means of determining the grant price, vesting schedules, termination provisions, acceleration rights and limitations, and relevant exclusions from any anti-dilution protections. Additionally, the company should consider whether to use *incentive stock options* in addition to *non-qualified options.*

c) Additional management

VC investors may insist that specific additional management-level employees be identified and retained at or promptly following the closing of the investment. In such a case, a key issue of discussion is the extent to which stock or options issued to additional key employees will dilute the holdings of the founders and other common stockholders alone or of all the stockholders (founders and key investors alike).

3) Protection/assurance of intellectual property

Where a key product or some form of intellectual property (IP) is important to the success of the company, venture investors will require assurances, in advance of closing, of the company's ownership rights, its ability to protect those rights, and of no infringement of the IP rights owned by others. Part of this assurance will occur during the due diligence process, in which the company will be required to provide assurances that any employees hired away from other companies are not bringing or using that previous employer's confidential or proprietary information and are not otherwise in violation of their agreements with such employers. Where

IP is authored or originated or a product or process is invented or patented by a particular individual, appropriate assignments to the company will be required. In addition, all significant employees may be required to sign a standard or agreed form of confidentiality, non-competition, non-solicitation, and assignment-of-inventions agreement. Hopefully, the company has provided for these in its advance, pre-financing planning.

Common Reasons for Failing to Attract Funding

Many companies seeking VC funding—including those that appear well-positioned and even deserving—do not obtain it. A number of factors are cited by VC professionals as reasons that particular businesses did not succeed in obtaining funding. A common reason for failing to attract venture capital is a lack of fit with the VC's particular objectives, criteria, and preferences (regarding such matters as market opportunity, stage of business development, location of business, management depth or track record, industry focus, speed to market, competitive dynamics, amount of required investment, investment round, or other factors). A second common reason is management deficiencies, whether in the sophistication, track record, priorities, depth, completeness, integrity, passion, or chemistry of the management team or its key members.

VCs may not fund a company because of what the investors regard as the unrealistic expectations or demands by founders or managers regarding valuation, priority rights, structure, or governance issues. In some cases, a VC may avoid a fund-seeking business because there is "too much complexity" or it is potentially too difficult to take on. For example, the VC may believe too many rights were granted or obligations undertaken in prior rounds of financing, or too many stockholders exist that do not add value. The VC may find evidence of potential or threatened disputes, or determine that core assets or uncertain liabilities are bound up in agreements-in-principle or ambiguous contracts, or find the corporate stock and minute books are incomplete and/or inconsistent with the company's c*ap table* and history of funding and development.

Another common reason cited by VCs for a failure to attract VC funding is that management ignored or did not fully understand, appreciate, or articulate the market and industry (size, growth, and trends); the competition (existing and anticipated); the technology, capacity, or other risks; the need for future rounds of financing (how much and when); or other demonstrable challenges or hurdles facing the company. VCs sometimes cite the founders' or managers' failure to demonstrate the compelling nature or dynamics of the market, strategy, or business. Perhaps the business plan, projections, and opportunity are not supportable (or are not as clear) following due diligence investigation. VCs may avoid a company if they believe that "this is a product, not a company," since VCs typically do not invest in single-product companies. Finally, they may view the company as a "waste of precious time" and fear that the owners are not serious or committed to outside or VC investment capital.

Angel Investing

Another source of start-up, early-stage, and expansion capital, which has become more prevalent and recognized recently, is funding from so-called angel investors: wealthy individuals who desire and are willing to invest time and money in companies that have both the right fit and the investment return potential for which the angel is looking.

1) More money, and more deals (at early stages)

A number of studies published on angel investing have concluded that, when compared to institutional VC investing, angels invest more money in far more companies (10 to 15 times more). This is particularly true in seed and early-stage financings, where angel investment has long played a vital role. It has been estimated that there are more than 250,000 active angel investors in the United States, investing more than $20 billion in some 30,000 businesses each year.

2) Dynamics of deal size

Because of the dynamics of institutional VC funding, the minimum first-round investment by most VC firms is now thought to be between $3 million and $5 million. VC firms have seen an increase in the size of funds and the number of portfolio compa-

nies, often without a commensurate increase in the VC firm's professional staffing. It takes the VC as much time to analyze, invest in, and oversee a small investment as it does a large one. These dynamics have given rise to a tremendous void for entrepreneurs and owners of emerging businesses seeking start-up or early-stage capital of between $100,000 and $2 million. Angel investors can and do fill this void, flying below the VC radar and providing funding at these lower levels.

3) Approach varies widely; dictates access and availability

The emerging business will find that receiving funding from an *angel* (or group of angels) presents many of the issues discussed earlier inherent in venture capital investments, but there are significant differences. Institutional VC investors are organized as professionally managed investment funds. The investors in VC funds are typically large institutions, pension plans, endowments, corporations, and some very wealthy individuals. VC funds employ professional staff and consultants to assist in identifying investment prospects, research, market analysis, due diligence, valuation, negotiation, documentation, closing, monitoring/nurturing/overseeing portfolio investments, developing and executing exit strategies, and communicating with fund investors. The VC is structured and staffed in a singularly focused (and rather disciplined and predictable) effort to make significant investments in promising companies to create exceptional investment returns for its fund investors. VCs also often invest in companies located long distances from the principal offices of the VC firm.

In comparison, many angel investors operate on their own, taking a *lone ranger approach.* The individual angel is often a successful entrepreneur who has cashed out (in a successful sale transaction), a member of a wealthy family, a prominent (often retired) executive, or a very high-income professional.

What is clear about these angels, compared to VC funds, is that they have much smaller amounts of capital to invest (so you may need multiple angels) and have limited time and resources available to identify, contact, perform due diligence on, value, negotiate, document, or close on a given investment opportunity. Angel investors also usually desire to (and, because of the early stage, need to) be actively involved with the company, using his or her knowledge, expertise, experience and contacts to assist in the company's direction, management, growth, and development. Because

of this, angels typically invest in what they know *(i.e.,* the market or industry in which they made their name or fortune), close to home, and alongside other investors the angel knows, trusts, and respects.

What is unclear (and what varies widely) is precisely what motivates or dictates a particular investment. Clearly, some level of investment performance or return is a given, but there are other, less tangible, even emotional (and thus rather unpredictable) factors that influence an angel's investment choices: investing only in the industry or sector the angel came from or is familiar with; socially responsible investing; goal-oriented investing; source-specific investing; and stage-specific investing (to name a few). The amount of time a given angel is willing or able (given other interests and commitments) to devote to this activity (sole passion vs. current pastime) and all of its components also varies widely. Based on these factors, understanding the wants and needs of, and ensuring the right fit with, a particular angel investor is paramount (from both the angel's and the company's perspective). Locating this needle in the haystack can be both frustrating and difficult.

Partly because of limitations in the *lone ranger approach* and partly in response to the difficulty of finding and sourcing angel investors, pools, networks, clubs, and groups of angels are being organized around the country at unprecedented rates. Although the approach and structure of these groups varies widely, the goal is common. By joining together, a cluster of angels can:

- See more deal flow.
- Take advantage of a broader, more diverse base of knowledge, expertise, experience, and contacts.[8]
- Reduce investment risk by strategically using its collective base of knowledge, experience, and contacts (or, in some cases, by employing staff) to better source, research, and screen non-starters and to provide value-added assistance in the fields of expertise of its participants.
- Enhance networking and strategic relationships.[9]

8. This can be instrumental in analyzing potential investment opportunities; performing due diligence; formulating a recommendation for investment; negotiating, documenting, and closing an investment; nurturing and fostering development; and assisting with later rounds of funding and exit strategies.
9. Networks with access to significant capital resources and a track record of investing become highly sought after—and thus attract more deal-flow and better investment opportunities.

Most of the existing angel networks focus on investments in specific geographic areas, markets, or industries. Their approach to investing varies from pure networking (where opportunities are presented to the group at periodic meetings and each angel determines whether and to what extent (s)he wants to proceed or invest), to a *fund approach* (where each angel commits or contributes capital to a limited partnership fund, then the group or a committee votes on which ventures to invest in and how much to invest). Issues of co-investing by individual angels have to be considered and resolved. While angel networking has enjoyed significant progress, it remains a "work in progress."

ANNEX A:

Illustrative Series A Investment Transaction Term Sheet

The following Illustrative Term Sheet has been prepared and edited based on my experience with Series A term sheets and venture capital negotiations and transactions. In assembling this document, I reviewed and analyzed many term sheets and letters of intent used (as a starting point) in Series A financings. I also reviewed term sheets available through venture capital website resources (including *www.NVCA.org*), as well as preliminary draft commentary prepared by an American Bar Association (Business Law Section—Venture Capital & Private Equity) subcommittee on which I serve.

This Term Sheet is presented for illustrative, educational, and informational purposes only, and is therefore over-inclusive. It does not constitute legal advice as to any particular facts, circumstances, or transactions.

Terms and language enclosed in brackets are variable, to be retained, modified, or deleted as necessary for a particular transaction.

NOTES

1. It is not uncommon for multiple investors to co-invest in a Series A financing round, in which case the Term Sheet must be adapted accordingly, and there may be additional considerations to address, relating to the coordination of (and dealing with the possible competing interests among) the investors, such as apportionment of board seats, how the investors take action, and the like.

[NAME OF COMPANY]

PROPOSED TERMS OF SERIES A CONVERTIBLE PREFERRED STOCK FINANCING

[date]

1. INVESTMENT SUMMARY

This Term Sheet summarizes the principal terms of the Series A Convertible Preferred Stock financing of [____________], Inc., a [Delaware] corporation (the "Company"). The securities issued to ____________ (the "Investor") [1] will have the characteristics, terms, and provisions described in this Term Sheet.

In consideration of the time, effort, and expense devoted and to be devoted by the Investor with respect to the investment transaction contemplated by this Term Sheet (the "Transaction"), the [Expenses (in Section 2), No Shop (in Section 6), and Confidentiality (in Section 6)] provisions hereof shall be binding and enforceable obligations of the parties, whether or not the financing is ultimately consummated. No other legally binding or enforceable obligations are intended to be, or are, created under this Term Sheet until and unless definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and it is conditioned upon the Investor's completion of due diligence, legal review, and documentation satisfactory to the Investor. The binding and enforceable provisions of this Term Sheet shall be governed in all respects by the internal laws of the State of [Delaware].

Offering/Investment Terms

Document Prep; Closing Date:

As soon as practicable following the Company's acceptance of this Term Sheet, the Investor will cause its counsel to prepare all of the documents necessary to complete the Transaction. The Transaction will be consummated at a closing (the "Closing") as soon as practicable following the parties' execution and delivery of the definitive purchase agreement and satisfaction of the conditions to closing specified therein. [It is

NOTES

2. The investment can be structured in stages, with an initial installment at closing and then subsequent installments if the Company meets certain designated and agreed-upon *milestones* (e.g., hiring key managers, reaching a revenue hurdle, completing project development, landing a specified number of customers, etc.) or after an agreed period of time has lapsed. This type of provision is not common, is generally not preferable to the Company, is difficult to negotiate, and may invite later controversy concerning the actual achievement of the milestones (and thus the receipt of milestone-based funding).
3. In addition to equity (e.g., preferred shares), a Series A financing round might also include promissory notes of the Company (subordinated to senior, bank debt) and/or warrants to purchase common stock (which will affect the Company's capitalization and, most likely, further dilute the Company's founders and other common stock owners). As noted above (see Note 2), some Series A financings (particularly in the early-stage life sciences space) provide for *staged* or *milestone-based financings*.
4. To the extent the Company does not have a director/executive/employee stock pool (via a stock option, restricted stock, or other incentive compensation plan) in place before the Transaction, the matter will be discussed in some detail. The Investor(s) can be expected (i) to require that the Company establish an appropriate employee incentive plan, which typically provides for allocation of a pool of shares of common stock—in the range of 7.5% to 25% of the Company's common stock on a fully diluted basis—to be available for grant as incentive compensation awards to employees (and directors, officers, and consultants) by, and at the discretion of, the Company's board of directors (or compensation committee); and (ii) to discuss (in advance) such matters as initial contemplated grants and voting and other terms.

planned that the signing of definitive agreements and the Closing will occur simultaneously on the same day.]

Investor:

______________ (and its affiliates) [and such additional investors as the Investor and the Company mutually agree]

*Amount of Investment: $*______________ [2]

Security Subject to Purchase:

Series A Convertible Preferred Stock (the "Series A Preferred"),[3] initially convertible into ____% of the fully diluted shares of common stock of the Company. (See Section 3 below.)

Price per Share:

$_____ per share (the "Original Purchase Price"), based on the capitalization of the Company set forth in the table below.

Pre-Money Valuation:

The Original Purchase Price is based upon a fully diluted, pre-money valuation of the Company of $__________ and a fully diluted, post-money valuation of the Company of $__________ (including an employee stock pool representing not more than __% of the fully diluted, post-money capitalization of the Company).

Capitalization/Capital Stock:

The Company's capital structure and capital stock ownership, before and after Closing, is set forth below:

	CURRENT OWNERSHIP	AFTER CLOSING OF INVESTMENT
Common Stock—Founders/Others	____%	____%
Common Stock—Employee Stock Pool [4]	____%	____%
Issued/Granted	____%	____%
Unissued/Available for Grant	____%	____%
Common Stock—Warrants (if any)	____%	____%
TOTAL:	____%	____%

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5. The precise use of all proceeds from the investment transaction will be discussed and agreed to by the parties. Whether existing shareholders (often founders) will be permitted to take some cash out of the Company (e.g., by redemption of common shares, dividend distribution, retirement of debt, etc.) is a matter to be negotiated, early on in the process. For the most part, the Investor can be expected to require that (i) the invested funds be used to drive the Company's growth and success; and (ii) continuing key executives and founders maintain a significant equity position in the Company to align interests (and keep "skin in the game").

6. Sometimes, as part of the valuation discussion, the Investor will want comfort that the Company's financial position at Closing is substantially as "assumed" (or promised) when it valued the Company and determined the amount of its investment (and the material terms of the Transaction). Thus, the Investor may ask for certification of certain *financial data points* as of Closing. Most often, this includes *working capital* and *debt*. This also introduces a discussion of whether the Investor will require delivery of audited financial statements (year-end and/or interim) as a condition to its investment and the Closing.

7. The Investor may request that the founders personally make representations and warranties (and provide indemnification for any breach, at least as to certain key matters). Some term sheets include specific representations/warranties that the Investor believes are important to "flag" from the start.

Uses of Funds:

The net proceeds of the Transaction will be used for ______________, for working capital, and for general corporate purposes.[5] The Company's fees and expenses relating to the Transaction ("Transaction Expenses") will be paid by the Company at closing.

[Balances at Closing:

At Closing, the Company will have minimum cash and working capital balances, and maximum indebtedness, in amounts which are consistent with the ________, 20___, financial statements as previously delivered to the Investor.][6]

2. PURCHASE & SALE OF SECURITIES

Definitive Agreement:

The purchase and sale of Series A Preferred shares shall be evidenced by a stock purchase agreement to be in form and substance satisfactory to the Company and the Investor.

Representations and Warranties:

Standard representations and warranties by the Company.[7]

Covenants:

Standard pre- and post-Closing covenants, including that the Company will be operated (and compensation awarded, dividends paid, and indebtedness incurred) solely in the ordinary course of business, consistent with past practice, from signing of definitive agreements through Closing.

Conditions:

Standard conditions to signing and Closing, which shall include, among others, (i) satisfactory completion of financial and legal due diligence (to be completed by signing of definitive agreements); (ii) no laws or court orders preventing consummation of the Transaction; (iii) the filing of an amendment to the Company's Certificate of Incorporation, establishing the rights, preferences, and limitations of the Series A Preferred shares; [(iv) execution and delivery by the Founders and identified senior management of non-competition and non-solicitation agreements satisfactory to the Investor]; [(v) audit of financial statements]; and (vi) an opinion of

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8. The terms and provisions (or, in *securities-speak,* the relative rights, preferences, and limitations) of the securities subject to purchase in the Transaction will be established and set forth in the Company's charter (in Delaware, a certificate of designation incorporated into the certificate of incorporation), which is a publicly filed and accessible document, available through the state of incorporation's Department or Secretary of State. The filing and amendment of the charter must follow certain procedures prescribed under state law (and, in the case of amendments, any limitations or requirements set forth in the charter). Various rights of the holders of preferred stock—vis-à-vis the company and other shareholders—are typically set forth in a separate *investor rights agreement* [see Section 4]. Care should be exercised with respect to provisions contained in the charter (which will run to all holders of shares) vs. those contained in agreements (which may contain various negotiated limitations, including on such matters as remedies, successors and transferees, survival, liability limitations, and alternative dispute resolution).
9. Dividend provisions come in all shapes and sizes. Cumulative dividends—which accrue and cumulate regardless of whether the board ever declares a dividend and which (in the case of companies that do not pay dividends) effectively increase the liquidation preference—are unusual; some term sheets provide for a cumulative dividend that begins at some point in the future (one to three years after the investment closing). In addition, accrued and unpaid dividends that become payable upon conversion of the Series A Preferred (to common shares) are likewise unusual. An alternative is to give the Company the option to pay accrued and unpaid dividends either in cash or in common shares; the latter are referred to as "PIK" (pay-in-kind) dividends. Dividends may also be participating (unusual) or non-participating. These provisions—which can result in some measure of dilution to founders and other common stock holders—need to be reviewed and negotiated with care.

counsel to the Company in form and substance satisfactory to the Investor.

Draft Agreements & Counsel:

Investor's counsel will prepare all of the documents necessary to complete the Transaction. It is anticipated that draft Transaction documents will be delivered to the Company's counsel within [five] business days of the Company's acceptance of this Term Sheet.

Company's Counsel:
[insert name and contact information]
____
____

Investor's Counsel:
[insert name and contact information]
____
____

Expenses

Contingent upon closing the Transaction, the Company shall pay the Investor's legal fees and expenses with respect to the Transaction, up to a maximum of $[______], which shall be payable at Closing. If the Transaction does not proceed to closing, each party will bear its own fees, costs, and Transaction Expenses.

3. DESCRIPTION OF SECURITIES—SERIES A PREFERRED SHARES [8]

Dividends:

The Series A Preferred will carry a non-cumulative dividend, at the rate of ____% per annum, which will be payable only when, as, and if declared by the Company's board of directors (and prior to any dividends payable to any other class of stock). [9]

NOTES

10. *Liquidation preference* is a key, central feature of any preferred stock, and it can seriously impact the value (and proceeds, if any, payable on the sale) of the common stock. There are many variations. The one included in this Term Sheet is a *non-participating* provision at one times (1x) the Original Purchase Price (note that, in the aftermath of the "bubble burst," super- or multiple liquidation preferences became more common, but these are unusual today). Other variants of liquidation preferences including (i) so-called *full participation features* where, after receiving their preferential amount, the holders of preferred stock are entitled to participate with the common stock in any and all distributions (or in the remaining assets of the company) on an as-converted basis (some call this "double dipping"); and (ii) a *capped participation right,* which in essence is a full participation right, except that the preferential payment amount is capped at some factor (e.g., two to five times) of the Original Purchase Price.
11. Optional conversion provisions are standard. Although the preferred holder is provided the right to convert its preferred shares to common shares at any time, the most likely situation in which a preferred holder would elect to convert is where the holder determines (e.g., on a liquidation event) that conversion to common stock would result in a higher return to the holder than remaining a preferred stock holder (and receiving the liquidation preference and participation rights, if any, incident to such ownership). Accordingly, the relationship and interplay between the conversion rights and the liquidation preference rights (see above) should be considered.
12. The *price per share test* seeks to ensure that the Investor achieves a substantial return on investment before the company can go public without the Investor's consent. As a practical matter, the Investor typically will control, or have certain controls over, the Company's decision to go public.

Liquidation Preference:

In the event of a liquidation, dissolution, or winding up of the Company (including any Deemed Liquidation Event, as defined below), the holders of the Series A Preferred will be entitled to receive, first and with priority over holders of common stock, the Original Purchase Price thereof [plus any accrued and unpaid dividends on each share of Series A Preferred].[10] The balance of any proceeds shall be distributed to holders of common stock.

A sale, merger, or consolidation of the Company (with an unaffiliated third party and for a *bona fide* business purpose, other than to facilitate financing from new or existing investors) and a sale, transfer, or disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "Deemed Liquidation Event"), thereby triggering payment of the liquidation preference described above to the Series A Preferred holders [, unless the holders of at least ____% of the Series A Preferred then outstanding elect otherwise].

Conversion:

<u>*Optional Conversion:*</u> The Series A Preferred may be converted into shares of common stock, at the option of the holders of at least ____% of the Series A Preferred then outstanding, without the payment of additional consideration at any time or from time to time. Initially, the conversion ratio shall be one-to-one (1:1) for shares of common stock, subject to adjustment for stock dividends, splits, combinations, and similar events, and as described below under *Anti-Dilution Provisions*.[11]

<u>*Mandatory Conversion:*</u> Each share of Series A Preferred will automatically be converted into common shares, at the then-applicable conversion rate, in the event of (i) the closing of a firm-commitment underwritten public offering of the common shares with a price per share of at least ____ times the Original Purchase Price (subject to normal anti-dilution adjustments) and with gross proceeds to the Company of at least $____ million (a "QPO");[12] (ii) the consummation of a Deemed Liquidation Event transaction at a fair market value of at least $____ million (a "Qualified Sale"); and (iii) upon the vote or written consent of the holders of at least ____% of

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13. These provisions are negotiated, with the percentage typically ranging from 33.3% to 66.6%. As with all percentage vote/consent thresholds, consideration should be given to whether any single investor (or group of affiliated investors or their transferees) can either control or block the vote or consent. When dealing with multiple series of preferred stock, it is important to understand the composition of each series's ownership to ensure that each series is getting the rights it bargained for. The company will want the percentage to be high enough to ensure that a substantial portion of the series is bought in.

14. Special anti-dilution provisions (here, protection in the event of a *down round)* come in several varieties. *Broad-based weighted average* protection is clearly the most commonly used formulation. In essence, the effect of the share issuance in the down round is spread over a broad base of shares (including unexercised options and outstanding convertible securities). *Full ratchet* provisions (more favorable to the Investor) are quite draconian and are typically resisted strenuously. If the Company lacks negotiating leverage and must agree to some form of full ratchet anti-dilution protection, then limitations should be negotiated on the applicability or severity of such provision (e.g., limited duration, pay-to-play, percentage ownership cap, share price floor, and other exceptions to ensure that adjustments are not triggered other than in connection with equity funding activities that involve a down round within a specified period of time).

15. The Investor can be expected to request a number and variety of restrictive covenant protections—actions that the Company may not take or effect unless all or a number of the Investor's designated and elected directors approve same. [See also the PROTECTIVE PROVISIONS section below.] Obviously, these need to be reviewed and negotiated with care, as they present the possibility that the Investor may block these actions (notwithstanding that they may be in the best interests of the Company and the shareholders as a whole).

16. In certain states (e.g., California), companies may not opt out of the statutory requirement of a separate class vote by common shareholders for certain transactions.

the shares of Series A Preferred then outstanding. [13]

Anti-Dilution Provisions:

In addition to normal and customary anti-dilution protections (e.g., adjustment for stock dividends, splits, combinations, and similar events), in the event that the Company issues additional securities at a purchase price (or deemed purchase price) that is less or lower than the then-current Series A Preferred conversion price, then such conversion price shall be adjusted based on a broad-based weighted average anti-dilution provision. [14]

For clarity, the following share issuances shall not trigger any anti-dilution adjustment ("Excluded Issuances"): (i) securities issuable upon conversion of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion (or exchange) of any note, debenture, warrant, option, or other convertible (or exchangeable) securities outstanding as of the Closing; (iii) common shares issuable upon a stock split, stock dividend, or any subdivision of the common shares; (iv) the issuance of up to [________] common shares (or of restricted shares, restricted share units, or options to purchase such shares) issued or issuable to employees or directors of, or consultants to, the Company, pursuant to any incentive compensation, stock option, or similar plan or arrangement approved by the Company's board of directors [, which approval shall include [at least __ of] the Series A Directors]; [15] [(v) securities issued or issuable to banks, equipment lessors, or vendors pursuant to a debt financing, equipment leasing, or real property leasing transaction or other transaction approved by the Company's board of directors [, which approval shall include at [____] of the Series A Directors]; (vi) securities issued in transactions of primarily a strategic and not a financial/investment nature, including pursuant to an acquisition of another business by the Company approved by the Company's board of directors [, which approval shall include [at least ___ of] the Series A Directors]; or (vii) securities issuances that are otherwise excluded by vote or written consent of the holders of at least [__]% of the Series A Preferred].

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17. Note that Section 242(b)(2) of the Delaware General Corporation Law provides that if any proposed charter amendment would alter the powers, preferences, and special rights of a series of preferred stock so as to affect them adversely, but not similarly adversely alter the powers, preferences, and special rights of the entire class of preferred stock, then the holders of that series are entitled to a separate class vote on the amendment.
18. This is a long list of possible restrictive covenants, and an Investor may request others. The Company may also request that the preferred holders vote together in favor of a Qualified Sale or other sale transaction so long as the preferred holders have received a specified return on their investment—in effect, if the preferred holders would receive less than a threshold amount (e.g., three times their original investment) in a Qualified Sale, then their (or a specified percentage of their) vote or consent would be required for the sale to proceed. All restrictive covenants requiring the Investor's vote or consent must be reviewed and negotiated with care. If non-standard (and seemingly onerous) covenants are acceded to, then any non-objectively verifiable covenants should be placed in the investor rights agreement (and not the charter) so that disputes can be addressed as breaches of contract actions possibly resolved through arbitration or some other alternative dispute resolution mechanism.

Voting Rights:

The Series A Preferred shall vote together with the common shares on an as-converted basis, and not as a separate class, on all matters submitted to a vote of stockholders, except (i) the Series A Preferred, as a class, shall be entitled to elect [_______] members of the Company's board of directors (the "Series A Directors"), (ii) as provided under "Protective Provisions" below or (iii) as required by law. [16]

Protective Provisions:

So long as at least [__]% of the Series A Preferred shares originally purchased by the Investor are outstanding, the Company will not, without the written consent of the holders of at least [__]% of the Series A Preferred shares then outstanding, either directly or by charter amendment, merger, consolidation, or otherwise:

(i) liquidate, dissolve or wind-up the affairs of the Company, or effect any Deemed Liquidation Event (other than a Qualified Sale); (ii) alter, amend or repeal any provision of the Company's Certificate of Incorporation [or Bylaws] in a manner adverse to the Series A Preferred; [17] (iii) create or authorize the creation of any new class or series of shares, having rights, preferences or privileges senior to [or on parity with] the Series A Preferred, or issue additional or increase the authorized number of Series A Preferred shares; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, [other than (a) stock repurchased from former employees or consultants in connection with the cessation of their employment/services, pursuant to existing contract rights, shareholders' agreements, incentive compensation plans, or as approved by the board of directors; or (b) as a result of the Company's exercise of its right of first refusal pursuant to the Right of First Refusal and Co-Sale Agreement noted under Section 5 below; (v) create or authorize the creation of any debt security, or enter into new (or extend existing) bank lines of credit, if the Company's aggregate indebtedness would exceed $[_______] [other than debt with no equity feature] [unless such debt security and/or lines of credit have received the prior approval of the board of directors, including the approval of [at least ___ of] the Series A Directors]; (vi) increase or decrease the size of the board of

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19. Alternatively, this provision could apply on a proportionate basis (e.g., if the Investor "plays" for half of its *pro rata* share, it receives half of the anti-dilution adjustment).
20. Pay-to-play provisions come in many shapes and sizes, and are often the subject of intense negotiation. Company counsel must keep in mind the interests of all investors in these provisions, and some (larger) venture capital investors have required that the pay-to-play provisions apply to any future financing, including up rounds. If the consequence for failure to "play" is losing some but not all rights (e.g., anything other than a forced conversion to common shares), the charter will need to have so-called *blank check preferred* (and perhaps other) provisions at least to the extent necessary to enable the Board to issue a *shadow* class of preferred stock with diminished rights in the event an investor fails to participate.
21. While in practice these rights are seldom (if ever) actually exercised, the right to force a redemption provides the Investor with leverage against the Company to work to effect an exit or liquidity event within a defined time horizon. Many Series A financings do not include a redemption provision. When included, the term may vary, but it seldom is for less than five years.
22. Due to statutory restrictions, it is unlikely that the Company would legally be permitted to redeem shares in the very circumstances where investors would most want redemption. Thus, investors sometimes request that certain penalty provisions take effect where redemption has been requested but the Company's available cash (flow) does not permit such redemption (e.g., providing that the redemption amount is paid in the form of a one- to three-year note to each holder of unredeemed Series A Preferred shares at a specified interest rate, and that the holders of a majority of the Series A Preferred shares are entitled to elect a majority of the Company's board of directors until the redemption amount is paid in full).
23. Investors' rights are typically set forth in a separate investor rights agreement, which may also include a separate shareholders' agreement as well as rights of first refusal, co-sale rights, and voting agreements. See note 8 on page B-8, and Section 5.

directors; [(vii) authorize any action that results in the sale, lease or transfer of material assets of the Company to any person other than a wholly-owned subsidiary of the Company; (viii) terminate the existing or appoint a new chief executive officer; or (x) change the Company's accounting practices or auditors].[18]

"Pay to Play" Provision:

[Unless the holders of at least [__]% of the Series A Preferred elect otherwise,] on any subsequent "down round" investment transaction, the Investor (and any transferees) is required to participate to the full extent of its participation rights (as described below) [, unless this participation requirement is waived by the Company's board of directors (including by [at least ____ of] the Series A Directors).] The holders of all shares of Series A Preferred[19] failing to do so will automatically [lose their anti-dilution protection rights] [lose their right to participate in future rounds] [convert to common shares and lose their right to designate or elect a board seat].[20]

Redemption Rights:

The Series A Preferred shares shall be redeemable from funds legally available therefor at the option of the holders of at least __% of the Series A Preferred then outstanding at any time following the [sixth] anniversary of the Closing at a price equal to the Original Purchase Price [plus accrued and unpaid dividends].[21] The redemption price shall be payable over three years in equal annual installments.[22] Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for the Series A Preferred shares of holders who expressly opt out)].

4. INVESTOR RIGHTS AGREEMENT[23]

Board of Directors' Matters

The Series A Directors shall be elected to the Company's board of directors (the "Board") as noted above. [The Board shall meet at least [monthly] [quarterly], unless otherwise agreed by a majority vote of the Board.]

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24. These covenants should be negotiated with care; they are unusual and often superfluous where the Investor-appointed directors generally control the Board (or key Board committees).

25. Note that Section 402 of the Sarbanes-Oxley Act of 2002 would require repayment of any such loans in full before the Company files an IPO registration statement with the SEC.

The Company's Board shall designate [audit, nominations, and compensation] committees, each of which shall include at least one Series A Director and at least one independent director.

The Company's charter shall include provisions providing for maximum limitation of liability and indemnification of Board members under applicable law. The Company will use its commercially reasonable best efforts to procure (to the extent commercially available) D&O insurance with a carrier and in an amount satisfactory to the Board. In the event the Company merges with another entity and is not the surviving corporation, or transfers all or substantially all of its assets, proper provisions shall be made so that successors of the Company shall assume the Company's obligations with respect to indemnification of Directors.

Matters Requiring Series A Director Approval:[24]

[So long as __% of the Series A Preferred shares originally issued in the Transaction remain outstanding], the Company will not, without Board approval, which approval must include the affirmative vote of [at least __ of] the Series A Director(s):

(i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, company, or other entity unless it is wholly-owned by the Company; (ii) make any loan or advance to any person, including, any employee or director,[25] except advances and similar expenditures in the ordinary course of business or under the terms of an employee stock, option or incentive plan approved by the Board; (iii) guarantee any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business; (iv) make any investment other than investments in prime commercial paper, money market funds, certificates of deposit in any United States bank having a net worth in excess of $100,000,000 or obligations issued or guaranteed by the United States of America, in each case having a maturity not longer than [two] years; (v) incur aggregate indebtedness in excess of $[_____] that is not already included in a Board-approved budget and capital plan, other than trade credit incurred in the ordinary course of

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26. Note that founders and senior management sometimes also seek registration rights with respect to some or all of their shares.

business; (vi) enter into or be a party to any transaction with any director, officer or employee of the Company or any family member or "affiliate" (as such term is defined in Rule 12b-2 promulgated under the Securities Exchange Act of 1934) of any such person; (vii) hire, fire, or change the compensation of any of the Company's executive officers, including approving any new or modifying any existing incentive compensation or option plans; or (viii) change the principal business of the Company, enter into any new line of business, or exit the current line of business.]

Employee Stock Options:

Immediately prior to the Closing, [______] shares will be added to the Company's employee stock [option] pool, resulting in an aggregate unallocated pool of [_______] shares of common stock.

Unless otherwise approved by the Board (or a committee established by the Board), which approval must include the affirmative vote of [at least __ of] the Series A Director(s), all employee stock options and shares of restricted stock shall vest as follows: [25% after one year, with the remaining shares vesting {annually/quarterly/monthly and} equally over the next three years].

Right to Participate Pro Rata in Future Investment Rounds:

The Investor shall have a *pro rata* right, based on its percentage equity ownership in the Company (assuming the conversion of all outstanding preferred shares into common shares and the exercise of all options outstanding under the Company's incentive compensation plans), to participate in subsequent issuances of equity securities by the Company (excluding those issuances listed as Excluded Issuances at the end of the ANTI-DILUTION PROVISIONS section of this Term Sheet) at the same price and on the same terms made available to other purchasers.

Registration Rights:

REGISTRABLE SECURITIES:

All shares of common stock issuable upon conversion of the Series A Preferred will be deemed "Registrable Securities."[26]

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27. Registration of the sale of shares in a public offering is an expensive matter (and, of course, the most expensive registration is the IPO). Generally, registration expenses include SEC filing fees, attorneys' fees, accounting and audit fees, printing expenses, and the travel and other costs of a "road show."

DEMAND REGISTRATION:

Upon the earlier of (i) [three to five] years after the Closing, or (ii) [six] months following an initial public offering of the Company's common stock ("IPO"), persons holding [__]% of the Registrable Securities may require [one] SEC registration by the Company of their shares. The aggregate offering price for such registration may not be less than $[5-10] million. A registration will count for this purpose only if (i) [all] [at least __% of the] Registrable Securities requested to be registered are registered, and (ii) the registration is completed or is withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).

FORM S-3 REGISTRATION:

The holders of [10%-33.3%] of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate offering price of at least $[1-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [one] per year.

PIGGYBACK REGISTRATION:

The holders of Registrable Securities will be entitled to "piggyback" registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered on a *pro rata* basis and to complete reduction in an IPO at the underwriter's discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other [junior] stockholders' shares are reduced [, subject to the right of the Founders first to sell up to [__]% of their common shares in an IPO or follow-on public offering].

EXPENSES:

The direct, out-of-pocket registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions) shall be borne by the Company. The Company will also pay the reasonable fees and expenses[, not to exceed $________,] of one special counsel to represent all the participating stockholders.[27]

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28. If a pension plan covered by the Employee Retirement Security Act of 1974 (an "ERISA Plan") invests in a venture fund, then all of the fund's assets—such as its investments in portfolio companies—are treated as assets of the ERISA Plan (and thus must be held in trust, with certain transactions prohibited), absent an exemption. Under one ERISA exemption, a venture fund is not deemed to hold ERISA plan assets if it qualifies as a venture capital operating company (a "VCOC"). To qualify as a VCOC, the fund must have at least 50% of its assets invested in "venture capital investments"; an investment in a portfolio company qualifies as such a "venture capital investment" if the fund obtains certain management rights with respect to the portfolio company. In order to build a case for an exemption from the ERISA Plan asset rules, the venture fund in such case will generally ask each of its portfolio companies to sign a management rights letter in connection with the fund's initial investment.

29. Note that non-compete and similar restrictions (other than in connection with the sale of a business) may not be enforceable, in whole or in part, in certain jurisdictions. Some VC investors do not require broad-based execution of such agreements for fear that such could be disruptive to the business or that employees will request additional consideration in exchange for signing a non-compete/non-solicit agreement. Others take the view that the Board should determine, on a case-by-case basis, whether any particular key employee must be required to sign such an agreement.

LOCK-UP:

The Investor shall agree, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company for a period of up to 180 days (plus up to an additional 18 days to the extent necessary to comply with applicable regulatory requirements) following the public offering [(provided that all directors and executive officers of the Company and all [1 – 5]% or greater stockholders agree to the same lock-up provision).

TERMINATION:

The Investor's registration rights shall terminate on the earlier of [three to five] years after an IPO, upon a Deemed Liquidation Event, or when [all] [at least _____% of the] shares of an Investor are eligible to be sold without restriction under Rule 144(k) within any 90-day period.

[Except for *pari passu* registration rights granted in connection with a future preferred stock or debt financing], no future registration rights may be granted without the consent of the holders of at least [a majority] of the Registrable Securities, unless such rights are clearly subordinate to the Investor's registration rights.

Management and Information Rights:

[A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.][28]

The Investor (by and through its designated representative) will be granted access to Company facilities and personnel during normal business hours and following reasonable advance notice. The Company will deliver to such Investor (i) annual and quarterly [and monthly] financial statements; (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget and plan forecasting the Company's revenues, expenses and cash position on a quarterly [and month-to-month] basis for the upcoming fiscal year; and (iii) promptly following the end of each calendar quarter, a current capitalization table [, certified by the CFO].

[Employment,] Non-Competition and Non-Solicitation Agreements: [29]

The Company and each Founder and each other identified key employee will enter into, at or prior to Closing, [an

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30. Certain exceptions are typically negotiated—for example, estate planning and *de minimis* transfers, any sale in a change-of-control transaction (where all stockholders are treated the same), and any *bona fide* gift to a charitable organization.

employment agreement consistent with the terms set forth on Exhibit ___ hereto and] a [two] year [non-competition] and non-solicitation agreement in form reasonably acceptable to the Investor.

[Non-Disclosure and Invention Assignment Agreement:

Each Founder, employee, and consultant with access to or influence over Company confidential information/trade secrets/inventions will enter into, at or prior to Closing, a non-disclosure and proprietary rights/invention assignment agreement in a form reasonably acceptable to the Investor.]

Key Person Insurance:

The Company shall use commercially reasonable best efforts to procure and maintain life insurance policies on the lives of ____________________ from an insurer and in an amount satisfactory to the Board. The proceeds of such policy shall be payable to the Company.

Termination:

All rights under the Investor Rights Agreement, other than registration rights, shall terminate upon the earliest of (i) an IPO; (ii) a Deemed Liquidation Event; and (iii) such time as no Series A Preferred shares remain outstanding.

5. RIGHT OF FIRST REFUSAL/CO-SALE & VOTING AGREEMENT

Right of First Refusal/Right of Co-Sale (Come-Along):

The Company first and the Investor second shall have a right of first refusal with respect to any shares of capital stock of the Company proposed to be sold or transferred by the Founders. Before any such person may sell shares, s/he will give the Investor an opportunity to participate in such sale (on a *pro rata* basis). These rights of first refusal and co-sale shall be subject to certain customary and agreed exceptions.[30]

[Company Right of First Refusal on Investor Sales:

The Company shall have a right of first refusal to acquire all securities proposed to be transferred or sold by an Investor, subject to customary and agreed exceptions.]

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Board of Directors/Voting Agreement:

Immediately after the Closing, the Board shall consist of [______] members. The Series A Preferred shares shall have the right to elect [____] Board member(s), who initially shall be [_________]. The Founders and holders of the common stock shall be entitled to elect [_____] Board member(s), one of whom shall be the President & Chief Executive Officer of the Company. The Series A Preferred shares and common shares, voting together as one class, shall be entitled to elect [_________] Board member(s) who have relevant industry experience, are not employed by the Company or affiliated with the Investor and who are mutually acceptable to the Founders and the Investor.

The directors shall be entitled to reimbursement of reasonable out-of-pocket costs and expenses for attendance at meetings of the Board.

[Drag Along:

The Founders [and all current and future holders of greater than [1]% of the Company's common stock (assuming conversion of preferred stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investor that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or other transaction in which 50% or more of the voting power of the Company is transferred [for a price that is (on a common equivalent basis) greater than [two] times the Original Purchase Price of the Series A Preferred, provided that the purchase price is distributed in accordance with the terms of the liquidation preference set forth herein], approved by [the Board] [and the holders of ___%] of the then-outstanding shares of Series A Preferred.

Termination:

All rights under the Right of First Refusal/Co-Sale and Voting Agreements shall terminate upon the earliest of (i) an IPO; (ii) a Deemed Liquidation Event; and (iii) such time as no Series A Preferred shares remain outstanding.

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31. VC investors sometimes request redemption rights on or vesting of founders' shares, particularly in early-stage deals where the amount of capital, effort, or ingenuity "invested" by founders is out of proportion to the shares owned (or the pre-money valuation proposed). These provisions are also included to discourage founders from leaving the company or selling their stock prematurely. This is a matter for discussion and negotiation. Suffice it to say that most founders vigorously resist these provisions, and many investment transactions do not include them.

6. OTHER PROVISIONS

[Vesting of Founders' Shares:

All Founders will own their shares outright, subject to the Company's right to purchase [up to __% of] such shares at original cost. The repurchase right covers [__]% of the Founders' shares for the first [12 months] after Closing; thereafter, the right lapses in equal [monthly] increments over the following [36] months.][31]

No Shop:

The Company agrees to work in good faith and expeditiously towards a Closing consistent with the terms and provisions described herein. The Company and the Founders agree that they will not, for a period of [30-90] days from the date this Term Sheet is accepted, take any action to solicit, initiate, encourage or assist in the submission of any proposal, negotiation or offer from any person or entity (other than the Investor) relating to the issuance and sale by the Company of any of its shares of capital stock [or the acquisition, sale, lease, license or other disposition of all or any material portion of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to any of the foregoing.

Confidentiality:

The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board and the Company's accountants and attorneys and other potential investors in this Transaction acceptable to the Investor, without the prior written consent of the Investor.

Information Requests:

The Company agrees to provide Investor with the information necessary to complete a due diligence and legal review satisfactory to the Investor, including making its personnel, business, and financial books and records available to Investor and its representatives during normal business hours following reasonable advance notice.

Expiration:

This Term Sheet automatically expires on [________ __, 20___] if not accepted (signed and returned to the Investor) by the Company [and the Founders] by that date.

NOTES

This Term Sheet sets forth a framework for proceeding with the Transaction outlined herein. The [Expenses (in Section 2), No Shop (in Section 6) and Confidentiality (in Section 6)] provisions of this Term Sheet shall be binding and enforceable obligations of the Company; provided, however, that the obligations under such provisions shall terminate and expire upon the earlier of (i) the abandonment of discussions by the parties with respect to the agreements and transactions contemplated by this Term Sheet, and (ii) the parties' execution and delivery of one or more definitive transaction agreements. No other legally binding or enforceable obligations are intended to be, or are, created until and unless definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned upon the Investor's completion of due diligence, legal review, and documentation satisfactory to the Investor.

Executed this ___ day of _________, 20__.

INVESTOR	**COMPANY**
____________________________	____________________________
Name:	*Name:*
Title:	*Title:*

[FOUNDERS]

____

By:

____

By:

ANNEX B:

Glossary of Venture Capital Terms and Jargon

As even the most casual observer will notice, venture capital has a language all its own (although some of the terms and phrases are shared with buyout transactions, private equity, and even acquisitions). Thus, a guide to some of the most commonly used terms and jargon should be insightful. This Glossary—which has been assembled from many sources (including the author's experience)—provides such a guide and should be read in conjunction with the main text and the illustrative term sheet (ANNEX A) included in this GUIDEBOOK.

The following is a list of terms and jargon commonly found or used in venture capital negotiations, term sheets, agreements, and transactions. The list is incomplete, and some definitions may have local, geographic, or industry variations. Words and phrases that appear in *italics* are defined elsewhere in the Glossary.

Term	Definition
"A" Round	A funding *round* in which Series A *preferred stock* is issued and sold to outside investors. This is typically the first institutional venture capital financing round (but may also include *angels* and other sophisticated investors). The "A" in the name comes from the use of Series A Preferred Stock, the securities issued in the round.
Accredited Investor	A *person* (including an individual, bank, trust, fund, or other entity) meeting certain net worth or income qualifications such that it is considered sufficiently sophisticated to make investment decisions without the need for regulatory protections. *Regulation D* under the *Securities Act* provides a safe-harbor exemption for *private placements* to accredited investors (so that these offerings need not be *registered* with the *SEC*).

Term	Definition
	Typical requirements for an individual (i.e., a natural person) to qualify as an accredited investor are: $1 million net worth at the time of purchase, or annual income exceeding $200,000 individually (or $300,000 with spouse) in each of the two most recent years (with an expectation of reaching the same income level in the current year). Directors and executive officers of the *issuer* also qualify as accredited investors.
Accrued Dividends	See *Cumulative Dividends* and *Dividends.*
Advisory Board	A group of outside advisors to a *portfolio company,* typically with experience and/or contacts in the company's industry and markets, formed for the purpose of providing informal advice and assistance to the company's management concerning a variety of strategic, business, and operating matters. An advisory board does not have the formality, role, or duties of the company's *board of directors.*
Affiliate	An affiliate of a specified *person* is another person controlling, controlled by, or under common control with the specified person. This tracks a definition in *SEC* rules often used in venture capital documents. The SEC deems a company's directors and executive officers, as well as controlling stockholders, to be affiliates of the company.
Affirmative Covenant	See *Covenant.*
Agreement-in-Principle	See *Letter of Intent.*
Angel; Angel Investor; Angel Investment	Someone who provides funding (and, in many cases, other "value adds") to *start-up* and very *early-stage* businesses. Angel investments usually precede investments by *venture capital funds* and usually provide seed capital of less than $1-2 million. Angel investors commonly are high-net-worth individuals (and often are accomplished entrepreneurs and former business executives).

Angel Groups	Organizations, associations, and networking groups (sometimes including a raised "fund") formed for the purpose of facilitating *angel investments* in *start-up* and very *early-stage* businesses.
Anti-Dilution Provision; Anti-Dilution Protection	A provision (in an *option, warrant,* or *convertible security)* intended to protect the holder from *dilution* of its ownership interest that may result from future sales or issuances of *capital stock* by the *issuer*. See also *Weighted Average Ratchet* and *Full Ratchet.*
Anti-Fraud Rules	Rules and regulations, promulgated under federal and state securities laws, that prohibit (and provide for penalties and remedies in the event of) fraud, which includes material misstatements and omissions of material information, in connection with the offer and sale of securities.
Automatic Conversion	A feature of a *convertible security,* whereby that security, upon the occurrence of certain specified events or transactions, automatically converts (without any action on the part of the holder or the *issuer*) into (and becomes) shares of *common stock*. See also *Convertible Preferred Stock*.
"B" Round	A funding *round* following the *"A" round,* in which Series B *preferred stock* is issued and sold to one or more outside investors (usually *venture capital funds*). This can be accomplished through existing and/or new investors. Subsequent rounds are called "C," "D," and so on.
Basket	Specific dollar limitations on *indemnity* claims or other provisions provided under an agreement (typically an investment or purchase agreement). For example, the agreement may provide that one party may bring indemnity claims against the other only if the aggregate amount of all claims exceeds a

	specified dollar amount. A "deductible" basket means that the specified dollar amount is exempt from, and only the excess over that amount is subject to, indemnity claims. A "threshold" (or "dollar-one") basket means that once the specified dollar amount is exceeded, the indemnified person can recover the full amount of all claims (from the first dollar).
Beneficial Ownership	Equitable rather than record ownership of *securities* (a term commonly used in venture capital documents). For purposes of Sections 13(d) and 13(g) of the *Exchange Act,* a beneficial owner of a security includes any *person* who, directly or indirectly, solely or jointly, holds (1) voting power, which includes the power to vote or to direct the voting of, such security; or (2) investment power, which includes the power to dispose of, or direct the disposition of, such security.
Beta Product	A product that is being tested by potential customers prior to being formally launched into the marketplace.
Blank Check Preferred Stock	*Preferred stock* that has been authorized in the *charter* of a *corporation,* but (i) the terms (and rights, preferences, and limitations) have not yet been designated by the *board of directors;* and (ii) the stock has not yet been issued or sold to investors. Thus, shares of the authorized preferred stock may be designated, issued, and sold (pursuant to board of director action) at a later date, with no requirement or need for shareholder vote or approval. See also *Certificate of Designation.*
Blocking Rights	See *Veto Rights*.
Blue Sky Laws	State laws that address (and, to some extent, regulate) the offer and sale of securities, enacted largely to protect the investing public against securities fraud.

Board of Directors; Board	The governing body of a *corporation*, charged with oversight of the management and direction of the corporation. Individual *directors* are elected (usually annually) by shareholders to serve on the board, and they owe certain fiduciary duties to the corporation's shareholders. *Venture capital funds* typically have the right to elect a specified number of board members (and, together with *founders*/management, to elect one or more independent directors). See also *Independent Director* and *Investor Rights Agreement.*
Board Observer Rights	A contractually provided right for an investor (or its designee) to attend all regular and special meetings of the *board of directors* (and often meetings of board committees). This also typically includes the right to receive information and notices that are provided to board (and committee) members. Importantly, a board observer does not have the right to vote as a board member and generally does not owe the company (as a board member) fiduciary duties.
Bootstrapping	Creative actions implemented by a *start-up* to minimize (or squeeze) expenses, work relationships, utilize resources, and/or build cash flow (and margin), thereby reducing, delaying, or eliminating the need for external capital funding.
Bridge Financing	Temporary (and sometimes emergency), limited funding that will eventually be replaced by permanent capital (from equity investors or debt lenders). In venture capital, a bridge loan is usually provided in the form of a short-term *note* (6 to 18 months) that converts to *preferred stock*. Typically, the bridge lender has the right to convert the note to preferred stock at a price that is discounted from the price of the preferred stock in the next financing *round*. The loan is intended to

	"bridge" the borrower to its next round of financing.
Bring-Down	The repetition (or the later making current) of *representations and warranties* (included in an investment or purchase agreement) after the date on which they were originally made (i.e., the agreement or signing date), principally in the context of conditions to the obligations of the parties to *close* an investment or acquisition transaction.
Broad-Based Weighted Average Ratchet	The most commonly used form of *anti-dilution provision* in venture capital transactions. See also *Weighted Average Ratchet.*
Burn Rate	The rate at which a business expends its (net) cash over a defined period (usually a month).
Business Judgment Rule	A legal presumption that judgments made by the *board of directors* of a *corporation* are presumed to be correct (i.e., in the best interests of the corporation and its shareholders) and will not be second-guessed by the reviewing court, so long as they are made in good faith, on an informed basis, without conflict or self-interest, and in a manner reasonably believed to be in the best interests of the corporation. This rule is grounded in state corporation law (i.e., the governing law of the state in which the corporation is organized).
Call Option	The right to buy a security at a specified price (or price range) within a specific time period. See also *Option*.
Cap	A maximum limit on *indemnity* claims or other provisions under a *definitive agreement*. Also referred to as a ceiling. *Participating preferred stock* may have the *participation* feature subject to a cap.
Capital Call	When a *venture capital fund* manager (usually a *general partner* in a *limited partnership*) requests or requires (pursuant to a previous

	pledge or commitment) that an investor in the fund (a *limited partner*) provide additional capital to the fund. Typically, the limited partners agree to a maximum investment amount, and the general partner makes a series of requests/demands for capital over time to the limited partners as opportunities to invest in *portfolio companies* arise.
Capitalization (or Cap) Table	A table showing the capitalization of a company, which typically includes all *securities* issued by the company, and the identity and security/share ownership of each security-holder (or, at least, of the significant ones). The Cap Table also lists the form of security (whether equity or debt), such as *common stock, preferred stock, warrants, options, senior debt,* and *subordinated debt.*
Capital Stock	The units of ownership (such as *common stock* and *preferred stock)* in a *corporation*, usually evidenced by stock certificates, as authorized in the corporation's *charter* (consistent with the state of incorporation's corporate laws). See also *Equity Securities*.
Carried Interest; Carry	In a *venture capital fund* organized as a *limited partnership*, the *general partner*'s share of the profits generated through the fund's performance. Typically, a fund must return the capital invested in it by *limited partners* plus an agreed *hurdle rate* (or preferred return) before the general partner can share in the profits of the fund. The general partner will then receive its agreed carried interest (also known as its "carry" or "promote"), which is the agreed share or split (with the limited partners) of the remaining profits. The carried interest, rather than the *management fee*, is the general partner's principal incentive to perform well and generate strong fund returns.
Ceiling	See *Cap.*

Certificate of Designation	A certificate filed by a *corporation* with the appropriate state agency attesting to the *board of directors'* designation of the terms, rights, preferences, and limitations of a series of *blank check preferred stock*. Once filed, the Certification of Designation becomes a part of the corporation's *charter* (and the authorizing instrument of the security in question).
Change of Control; Change-of-Control Provision	A provision in an agreement pursuant to which one party's change of control triggers certain rights of another party, such as the right to terminate the agreement, or the acceleration or vesting of certain rights/interests/obligations under the agreement. What constitutes a "change of control" is often defined by reference to the sale or transfer of ownership of a specified percentage or amount of *voting stock* or assets, or a significant change in the composition of the *board of directors* (or other governing body).
Charter	The principal governing document of a company, as provided under the governing corporate law of the state of organization, prepared and filed when the company is first formed. Typically named the certificate of incorporation or articles of incorporation in the case of a corporation (or, in the case of a limited liability company, the certificate of formation).
Clawback	A contractual provision in a *private equity* or *venture capital fund*'s governing documents which provides that, over the life of the fund, the fund's managers will not receive a greater share of the fund's distributions than what they agreed and bargained for. Generally, this means that the general partner of the fund may not keep more than a specified percentage (e.g., 20%) of the fund's cumulative profits (and thus must return any "excess" to the fund's limited partners).

Closing	The process of consummating (or the consummation of) an investment transaction in which the requisite final (executed and delivered) legal documents and investment funds are exchanged and delivered. At the closing of an investment transaction, the investor receives the *securities* purchased, and the company receives funding.
Club Deal	An investment transaction in which several fund investors invest side by side in the same *round*. Although this term is most commonly used in *private equity fund*/buyout deals, it is also used in multi-fund venture capital transactions.
Committed Capital	The total amount of capital committed or pledged to a *private equity* or venture capital fund and available for the purchase of or investment in *portfolio companies*.
Common Stock	The most basic form of equity ownership, and a unit of ownership, in a corporation. Common stock is the most junior form of *equity security*. Usually, company *founders,* management, employees, and *friends and family* own common stock, while outside investors purchase and own *preferred stock*. Holders of common stock are entitled to vote for the election of directors and other matters requiring a shareholder vote; to the payment of *dividends* (if, as, and when declared and paid); and to distribution of all remaining proceeds in *liquidation* (after the claims of the secured and unsecured creditors and bondholders, and the *liquidation preferences* of the preferred stockholders, are satisfied).
Confidentiality Agreement	A stand-alone agreement or a provision in a *letter of intent* or *definitive agreement,* whereby one party agrees to treat as confidential, and not to disclose to others, nonpublic information received from the other

Term	Definition
	party. Sometimes also called an *NDA* or *non-disclosure agreement.*
Conversion Ratio	The ratio used to determine the number of shares of stock into which a *convertible security* may be converted. In a venture capital transaction, this refers to the ratio that determines, at any point in time, the number of shares of *common stock* into which shares of *convertible preferred stock* may be converted.
Conversion Rights	Rights under which shares of *preferred stock* (or other *convertible securities*) "convert" into (and become) shares of *common stock.* Can be automatic or mandatory (in certain specified events, such as a *qualified sale, qualified IPO,* satisfaction of financial performance targets, and/or approval by a specified vote of preferred stock holders), as well as voluntary (i.e., at the option of the holder). These rights are typically protected by *anti-dilution provisions.*
Convertible Preferred Stock	A type of *preferred stock* that is convertible into or exchangeable for shares of *common stock* at a specified (and adjustable) *conversion ratio*. Convertible preferred stock is clearly the most commonly used form of *security* for venture capital investment transactions. See also *Conversion Rights.*
Convertible Security	A *security* of a company that by its terms is convertible into exchangeable for another security of the same company (e.g., *convertible preferred stock,* convertible *notes,* and convertible *debentures* can be convertible into shares of *common stock*). See also *Convertible Preferred Stock* and *Conversion Rights*.
Corporate Charter	See *Charter.*
Corporation	A legal entity organized under state law through the filing of a *charter*. The corpora-

	tion is owned by its stockholders (or shareholders), managed by its officers, and overseen/directed by its *board of directors*.
Co-Sale Rights	See *Tag-Along Rights.*
Covenant	A legal promise in a *definitive agreement* that obligates a party either to take an action (referred to as an *affirmative covenant*) or refrain from taking an action (a *negative covenant*); or that requires the maintenance or achievement of some defined economic, operating, or financial measure (a *financial covenant*).
Cram-Down Round	A funding *round* in which new investors (usually bringing substantial capital into the company and/or in a *down round*) demand and receive contractual provisions, contractual concessions, and new *securities* that significantly reduce (or *dilute*) the ownership percentage (and rights and protections) of previous investors. See also *Washout Round.*
Credit Agreement	A *definitive agreement* under which one or more parties (the "lenders") provide credit facilities (i.e., funds available to be borrowed), such as a term loan and/or *revolving facilities,* to another *person* (the "borrower"), subject to compliance with certain *covenants* and avoidance of certain *events of default.* The credit agreement typically provides for the most senior, secured credit arrangements of the borrower.
Cumulative Dividends	The right of a holder of *preferred stock* to receive accrued (and previously unpaid) *dividends* at a fixed rate in full before any dividends may be paid to the holders of any other, junior classes of *capital stock* (including *common stock*). Thus, dividends may accrue and "accumulate" at a fixed rate (e.g., 6% to 9% per annum) or may simply be payable "when, as, and if declared" by a company's *board of directors.* Because venture-

	backed *portfolio companies* typically need to conserve cash (and thus do not pay dividends), employing a cumulative dividend feature means the *liquidation preference* of the underlying preferred stock increases by an amount equal to the accrued cumulative dividend. Cumulative dividends are often waived if the preferred stock converts to common stock prior to an *IPO* or other significant transaction, but may be included in the liquidation preference (or as an adjustment to the *conversion ratio*) for other purposes.
Data Room	The place or site (which can be virtual or web-based) in which a company's material documents, contracts, books, and records are placed to be examined by potential investors in connection with their *due diligence*.
Debenture	Generally, longer-term *notes* issued to a number of investors (debenture holders) pursuant to an indenture and a debenture purchase agreement. See also *Note.*
Debt Security	A *security* representing a debt obligation of an *issuer*. A debt security is in many ways functionally equivalent to a bank loan, but the terminology is different: a lender makes loans to a borrower under a *credit agreement,* while an issuer issues and sells debt securities to a purchaser, pursuant to an indenture or note purchase agreement.
Definitive Agreement	The final form of signed agreement to undertake and consummate a transaction (e.g., a venture capital investment transaction), which by its terms is legally binding and enforceable (subject to the fulfillment or waiver of certain specified conditions).
Demand Rights	See *Registration Rights.*
Dilution	A reduction in the percentage ownership or the value of *equity security* holdings of a given shareholder (e.g., a *founder,* employee, or

	previous investor) caused by the issuance, or potential issuance, of additional equity securities (or rights to acquire equity securities).
Dilution Protection	See *Anti-Dilution Provision.*
Director	An individual member of a *corporation's board of directors,* usually elected annually by the corporation's shareholders.
Disclosure Schedule	An exhibit (or schedule) attached to a *definitive agreement* that describes exceptions to the *representations and warranties* (and, in some cases, *covenants*) of the parties in an investment transaction. Sometimes also called a *schedule of exceptions.* Once a definitive agreement is prepared by the investor's counsel, it is the *issuer's* obligation to prepare appropriate, complete, and responsive disclosure schedules (which will form part of the definitive agreement). This is also part of the *due diligence* process.
Discounted Cash Flow (DCF)	A valuation methodology whereby the present value of all future cash flows expected from a company is calculated (or "discounted"), based on accepted valuation tools and assumptions.
Dividend	A payment (or distribution) that is authorized and declared by the *board of directors,* to be made in respect of the outstanding shares of *capital stock* (or class or series of such stock, on a pro rata basis). Dividends may be *cumulative, non-cumulative,* participating, and non-participating. See also *Cumulative Dividends*.
Down Round	A *round* of financing (i.e., a separate, later investment transaction) in which the valuation of the company (and thus the effective price per share) is lower than the valuation utilized (and embraced in securities issued and sold) in a previous *round.*

Term	Definition
Drag-Along Rights	Contractual rights (typically provided in a *shareholders' agreement* or *investor rights agreement*) that allow one or more investors/shareholders (often those holding a majority or a specified percentage of the outstanding shares) to force (or "drag") all other shareholders to agree to and/or participate in a specific action, such as the sale of the company, alongside the initiating investor/shareholder. This provision operates to prevent minority shareholders from blocking a sale of the company (approved by the majority) by refusing to sell their shares.
Draw Down	See *Capital Call*.
Due Diligence	The fact-finding process by which a potential investor investigates the *issuer* to assess a potential investment and the accuracy of information provided. This process typically involves a review of the issuer's business, financial, accounting, personnel, regulatory, and legal contracts, books, and records; discussions with management; visits to facilities; and review of other pertinent information. The purpose is to assess the desirability, value, terms, and potential risks and upside incident to an investment opportunity.
Due Diligence Out	A provision in a *definitive agreement* relating to an investment, which gives a party the right to terminate the agreement (and not close the investment transaction) if it is not satisfied with the results of its *due diligence* investigation.
Early Stage	The stage of development of a company at the beginning of its corporate life (and its journey from *start-up* to full maturity). Although definitions may vary by audience, industry, and geography, the early stage of a company is commonly viewed as following the seed (formation) stage and before its middle or *growth stage*. Typically, a company in

	its early stage will have a core (but not complete) management team, a developed business plan, and a product or service (perhaps beginning to make sales), but no established customers, positive cash flow, or profits.
EBIT; EBITDA	A company's earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation, and amortization (EBITDA) are both measures of a company's operating cash flow. These measures are often used by sophisticated investors as a basis for valuing the company and pricing their investment. A key valuation methodology is based on a comparison of comparable private and public companies' values as a multiple of EBIT or EBITDA, properly discounted.
Elevator Pitch	A very concise oral presentation, lasting only a few minutes (the duration of an elevator ride), by an entrepreneur (or business owner or manager) to a potential investor concerning the business model, strategy, market, and solution (and the compelling investment opportunity presented) of the company in question.
Equity Securities	*Securities* evidencing the equity and ownership rights in (the *capital stock* of) a company or business entity. In a corporation, equity securities include *common stock, preferred stock, options, warrants,* and the rights (including conversion and exchange rights) to acquire these. Together, the equity securities represent the ownership of the company.
Event of Default	An event, act, or occurrence that allows a party to a *definitive agreement* to exercise specific remedies under that agreement, such as the acceleration of the obligation to repay *debt* under a *credit agreement.*
Exchange Act	See *Securities Exchange Act.*
Exclusive	See *No-Shop.*

Exercise Price	The price at which an *option* or *warrant* can be exercised (i.e., the purchase price for the shares or *securities* covered by the option or warrant).
Exit; Exit Strategy	The means (or plan) by which a *venture capital fund* (or other investor) monetizes and realizes a return on its investment in a *portfolio company*. This typically comes when the portfolio company is sold to another *person,* goes public in an *IPO,* or recapitalizes (e.g., *leverages* its balance sheet and pays *dividends* to and/or purchases securities from shareholders).
Expansion Stage	The stage of development of a company characterized by a complete management team, a proven business model (and product/service), customers, profitability, and a substantial increase in revenues (and, perhaps, revenue channels).
Financial Covenant	See *Covenant.*
Finder	A *person* who helps to arrange an investment transaction, usually by introducing one or more potential investors to a fund-seeking company.
First Offer Rights	See *Right of First Offer.*
First Refusal Rights	See *Right of First Refusal.*
Follow-On Funding; Follow-On Investment	An additional investment in a company made by its existing (or previous) investors. *Portfolio companies* often require more than one *round* of funding.
Forced Buyback	See *Mandatory Redemption.*
Founder(s)	The original owner(s) of a business entity, who started, organized, and participated in the conceptual development of the entity. Typically, a founder owns only *common stock* and manages the company until it has

	sufficient resources to attract and retain professional management.
Founders' Shares	Shares of *common stock* owned by the company's *founders* upon (and in connection with) the company's organization.
Founder Vesting	A requirement imposed by outside investors that *founders' shares* "vest" (in effect, be earned) over a period of years before they are fully owned (and may be sold or transferred). This is typically required (if at all) early in the valuation and investment process (e.g., *seed* and *early-stage* financings), to ensure that *founders* do not receive a windfall from their initial share allocations and to discourage founders from leaving the company or selling their shares prematurely.
Friends and Family Financing	Investment capital or an investment *round* provided by the friends and family members of the *founders* (and perhaps the initial management) of an *early-stage* company.
Full Ratchet	A type of *anti-dilution provision* that is favorable to the investor. It adjusts the *exercise price* or *conversion ratio* of a *security* to the lowest price at which securities (including *convertible securities, options,* and *warrants*) are, or any single share is, issued after the issuance of the subject security (i.e., the one entitled to the full ratchet provision). As a result of the implementation of a full ratchet, *founders,* management, and others who own *common stock* typically suffer significant *dilution*.
Fully Diluted	The number of shares (typically expressed as outstanding shares) representing the total potential ownership of a company, including all issued shares of *capital stock,* the conversion of all *convertible securities,* the exchange of all exchangeable *securities,* and the exercise of all *options* and *warrants*. This is an important (i) methodology for calculat-

Term	Definition
	ing any per share ratios; (ii) entry/line item in the *Capitalization Table;* and (iii) consideration in valuation discussions (and the negotiation of *anti-dilution provisions*).
Gatekeepers	Intermediaries (e.g., attorneys, accountants, bankers, and consultants), whom *venture capital funds* use as sounding boards and advisors in sourcing and gaining introductions to potential *portfolio company* investments.
General Partner	With respect to a *venture capital fund* organized as a *limited partnership*, the *person* responsible for all aspects of managing the fund, including communicating with *limited partners*, raising funds, making portfolio investment decisions, nurturing *portfolio companies,* and assisting with *exits*. The general partner, which retains liability for the actions of the partnership, earns a *management fee* as well as an agreed share of the fund's profits (known as the *carried interest*). See also *Limited Partners* and *Limited Partnership*.
Growth Stage	The stage of development of a company when it has already received one or more *rounds* of financing and is beginning to generate revenue (at an increasing rate) from its proven product or service. Follows the *early stage*, and precedes the *expansion stage*.
Hell or High Water	A phrase used to describe a *definitive agreement* having few, if any, conditions to *closing*. Once the hell-or-high-water definitive agreement is signed, there are very few "outs" and thus (generally) the parties must proceed to closing.
Hockey Stick Projections	The upward shape of a graph or chart showing revenue, *EBIT,* customers, or some other financial or operations measure that increases dramatically at some point in the future. *Founders*/entrepreneurs have been known to

	develop business plans that include hockey stick projections to attract the interest of potential investors (including venture capitalists).
Hurdle Rate	The minimum preferred return to *limited partners* in a *venture capital fund* (organized as a *limited partnership*) to be achieved before the *general partner's* (or manager's) *carried interest* is permitted. A hurdle rate of 10% means that the venture capital fund must achieve a return of at least 10% per annum on invested assets (for its limited partners) before the remaining profits are shared (with the general partner) according to the carried interest arrangement. Also referred to as the preferred return.
Incentive Stock Options (ISOs)	*Options* that are entitled to favorable tax treatment for the holder under the Internal Revenue Code (e.g., the holder does not pay tax on exercise and can achieve long-term capital gains more easily).
Incubator	An organization or entity designed to host and nurture *start-up* companies (including business concepts and new technologies) to the point that they become attractive to professional management, *angels,* and even *venture capital funds*. An incubator typically provides both physical space and some or all of the services—back-office/administrative, legal, accounting, technical, support/networking, etc.—needed for a business to proceed from concept to *early stage.* Incubators typically charge both a fee and a percentage of the equity for these services.
Indemnity; Indemnification	Provisions in a *definitive agreement* providing one party post-*closing* legal rights against the other party for breach of the other's *representations and warranties* or *covenants* that *survive* the closing, as well as the right to recover legal fees and expenses incident to prosecuting such legal rights. Often

	subject to a *basket,* a *cap,* and other negotiated limitations and exclusions.
Independent (or Disinterested) Director	A member of a *board of directors* who has no ties or affiliations with either company insiders (e.g., *founders* and management) or outside investors. *Investor rights agreements* commonly provide for the election of one or more independent directors. For public companies, *SEC* and stock exchange rules provide elaborate, detailed definitions and requirements as to who qualifies as an independent or disinterested director.
Initial Public Offering (IPO)	A corporation's first offer and sale of stock to the public pursuant to a *registration statement* (and prospectus) filed with and declared effective by the SEC under the *Securities Act.* Typically, the IPO is underwritten by an investment banking firm, with the shares listed or quoted on a national securities exchange or stock quotation system (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ).
Institutional Investors	Large, asset-rich organizations that invest their funds in a variety of investments and asset classes and on an ongoing, professional basis; typically banks, insurance companies, pension funds, investment companies, mutual funds, and endowments. Together with high-net-worth individuals, these comprise the most significant investors (and limited partners) in *venture capital funds*.
Intellectual Property (IP)	A business's intangible (non-physical) but often valuable assets, such as its patents, trademarks, copyrights, and "brand." The protection of intellectual property can create distinct competitive advantages and can be vital to a venture's fund-raising and growth prospects.

Term	Definition
Internal Rate of Return (IRR)	The interest/discount rate (expressed as a return on capital invested) at which a specific amount of capital invested today would have to grow in order to reach a specific value at a specific time in the future. This is the standard, accepted benchmark *venture capital funds* (and their limited partners) utilize to measure and compare their relative performance.
Investor Rights Agreement	A key *definitive agreement* in a venture capital investment transaction, typically providing for various obligations of the *issuer* and existing owners, and rights of new investors.
ISOs	See *Incentive Stock Options.*
Issuer	A business entity that issues (or proposes to issue) *equity securities* and/or *debt securities*. In a venture capital investment transaction, the issuer is the company or *corporation* that is the subject of the financing.
Later Stage	The stage of development of a company that has proven its concept, achieved significant and increasing revenues (compared to its competitors), and is approaching (or has achieved) break-even or positive cash flow. Typically, a later-stage company has completed its *expansion stage* and is nearing a *liquidity* or *exit event*.
Lead Investor	The *person* or *venture capital fund* that organizes a *round* of financing, leads the round (e.g., in such matters as *due diligence,* valuation, *LOI* preparation, negotiations, documentation, and *closing*), and usually contributes the largest amount of capital to the round.
Letter of Intent (LOI)	A written expression, in the form of a letter, of two (or more) parties' intentions to effect an investment transaction. It summarizes the material terms of the deal and other matters,

	and serves as the basis for preparing a *definitive agreement.* By its terms, an *LOI* generally is not legally binding (except that it may include certain legally binding provisions—typically those addressing *confidentiality, no-shop* agreements, and expenses). Sometimes also referred to as a *term sheet, memorandum of understanding,* or *agreement in principle.*
Leverage	Commonly refers to the addition of debt (via borrowings) to a company's capital structure in order to magnify potential equity returns.
Limited Partners	With respect to a *venture capital fund* organized as a *limited partnership*, high-net-worth individuals and *institutional investors* that contribute capital to the fund, are not involved in the management of the fund, and enjoy limited liability with respect to actions by the fund. See also *General Partner* and *Limited Partnership.*
Limited Partnership	With respect to a *venture capital fund,* a legal entity comprised of a *general partner,* which manages the fund, and *limited partners,* who contribute capital but have limited liability and are not involved with the management of the fund. The most common form of organization adopted by *venture capital funds. See* also *General Partner* and *Limited Partner.*
Limited Liability Company (LLC)	An entity, created via authorizing state statutory provisions (and typically a *charter* and LLC operating agreement), that offers limited liability to its members (or owners) and is eligible for *pass-through entity* tax treatment.
Liquidation	The process of selling off the (remaining) assets of a company and distributing the proceeds to the company's equity holders, in accordance with their preference or *priority* and *pro rata* interests, after the satisfaction of all debts and liabilities. In the context of *pre-*

	ferred stock, certain events or transactions (such as a *change of control*) may constitute a "deemed liquidation" (thereby entitling the holder to receive the *liquidation preference* applicable to its shares of *preferred stock*).
Liquidation Preference	The right to receive a specific value or amount for shares of *preferred stock* (or *equity securities* with preferential rights) if the company is *liquidated* (or deemed to be liquidated) in *priority* to amounts to be distributed on other (junior) securities. The liquidation preference is usually fixed at the original investment amount.
Liquidity Event	See *Exit*.
LOI	Acronym for a *letter of intent*.
Management Fee	An annual fee, typically fixed at a percentage of the *limited partners'* capital commitments to the fund, designed to cover the basic costs of running and administering a *venture capital fund.* The management fee is not intended to work as incentive compensation for the *General Partner*—that is the purpose of the *carried interest*.
Mandatory Redemption	The right of a security holder (e.g., of *convertible preferred stock*) to require the redemption (i.e., repurchase by the issuer) of some or all of the security held at a specified (or determinable) price and after a specified period of time has elapsed (a sufficiently long period of time such that the holders of the security, if they have not achieved *liquidity* by then, are disappointed and require negotiation leverage to cause the company to pursue an *exit strategy*). The purchase price is usually the original investment price plus any *accrued* and unpaid *dividends*. Also referred to as a forced buyback.
Market Capitalization	The aggregate value of a business based on the dollar value of all issued and outstanding

	securities. The market cap is computed by multiplying the number of outstanding shares by the current price per share.
Memorandum of Understanding (MOU)	See *Letter of Intent*.
Milestone-Based Investing	See *Staged Investing*.
Minority Protections	Rights provided to minority shareholders affording protection against actions taken (or potentially taken) by majority or controlling shareholders. May include *veto rights, tag-along rights, preemptive rights,* etc.
MOU	Acronym for a *memorandum of understanding*.
Multiple Liquidation Preference	When the *liquidation preference* of a *preferred stock* is fixed at a multiple (e.g., 2x to 4x) of the amount invested (on a per-share basis). See also *Liquidation Preference*.
Narrow-Based Weighted Average Ratchet	A form of *anti-dilution provision* used in venture capital transactions. See also *Weighted Average Ratchet*.
NDA	Acronym for a *non-disclosure agreement*.
Negative Covenant	See *Covenant*.
No-Hire Provision	See *Non-Solicit*.
No-Raid Provision	See *Non-Solicit*.
No-Shop	An agreement (usually in the *letter of intent* or *term sheet*) whereby the *issuer* gives an investor an exclusive right during a limited time period to negotiate and enter into a *definitive agreement* with the issuer, and agrees not to solicit or encourage other investment proposals during that period or to talk (or, if specified, to provide information) to other potential investors.

Non-Compete	A contractual provision in which one party agrees not to work for another (competitive) party or engage in activities that are competitive with (or to organize, manage, or own a business competitive with) the other party. In connection with an investment transaction, *founders* as well as senior management and key employees are typically asked to enter into non-compete agreements.
Non-Cumulative Dividends	*Dividends* that are payable to owners of *preferred stock* at a specific point in time only (i) if there is sufficient cash available to pay the dividends after all company expenses are paid, and (ii) as, if, and when declared by the *board of directors.* If cash flow is insufficient, the *preferred stock* owners will not receive dividends with respect to that time period and will have to wait until the board of directors declares dividends in the future.
Non-Disclosure Agreement (NDA)	An agreement often used by entrepreneurs and emerging business owners (before delivery of a business plan, financial statements, product information, customer information, projections, etc., to potential investors) to protect the confidentiality of company-related information to be provided to third parties. See also *Confidentiality Agreement.*
Non-Qualified Stock Options (NQs or NQSOs)	Stock *options* that are not eligible to be treated as *ISOs* (or *Incentive Stock Options*) for income tax purposes.
Non-Solicit	A provision in a *definitive agreement* or a *letter of intent* prohibiting one party *for a specified period* from soliciting for employment the employees of the other party. Also referred to as a no-raid provision. The provision can also be expressed as a restriction on hiring such employees (as opposed to soliciting them), in which case it is referred to as a no-hire provision.

Note	A document that evidences a debt obligation of a company (specifying, among other things, the amount borrowed, applicable interest rate, *covenants, events of default,* and maturity). The company in this case is referred to as the obligor, and the person advancing the funds is referred to as the holder. Longer-term notes are often referred to as *debentures*.
Option	The right to purchase *equity securities* in a company at a specified price (referred to as the *exercise price*) within or over a specified time period. Primarily awarded to management and key employees, typically awarded in the discretion of (and with the terms and provisions determined by) the *board of directors* or a board compensation committee, pursuant to a shareholder-approved option (or incentive compensation) plan.
Option Pool	The number of shares of *common stock* that are set aside for issuance upon the exercise of *options* or other equity-based incentives, to be granted by the board of directors in the future to management and key employees (and perhaps others). The amount of the option pool varies (from 7.5% to 25%), but it averages around 15% of *fully diluted* shares.
Outstanding Shares	The number of shares of stock that have been issued and are in the hands of investors/shareholders. This does **not** include treasury shares or shares that may in the future be issued in the event (i) *convertible securities* are converted, (ii) exchangeable securities are exchanged, or (iii) *options, warrants,* and other rights to purchase stock are exercised.
Pari Passu	Equally; ratably; without preference. Generally used to describe *securities* that are to be treated as being of equal *priority*.

Participating Preferred Stock	A type of *preferred stock* that is entitled to participate (or share) with holders of *common stock* in *dividends* and/or *liquidation* payments (after and in addition to collecting any stated *liquidation preference* or dividend rights). Where participating preferred stock is utilized, the participation feature may be subject to a *cap* (e.g., at two or three times the investment amount). See also *Participation*.
Participation	The right of a holder of *preferred stock* to enjoy the rights associated with its preferred stock and also to participate in any benefits available to *common stock* without converting to common stock. This may occur with respect to the *liquidation preference* (where a series of preferred stock has the right to receive its liquidation preference and then also to share in whatever funds remain to be distributed to common stock holders) and *dividends* (where, after a holder receives its *cumulative dividend,* it also has the right to receive any dividend payable on the common stock).
Pass-Through Entity	An entity that is generally disregarded for federal income tax purposes, resulting in no entity-level taxation and the entity's owners or partners recognizing income tax burdens and benefits (which "pass through" the entity) immediately, whether or not they have received a distribution. The most common pass-through entities are *"S" corporations, limited liability companies, limited partnerships,* and limited liability partnerships.
Payment-in-Kind (PIK)	A feature of a *security* pursuant to which *dividends* (in the case of an *equity security*) or interest (in the case of a *debt security)* are paid in the form of additional *securities* of the same type, instead of cash.
Pay-to-Play Provision	A contractual provision requiring an existing investor to participate on a *pro rata* basis in a

	subsequent investment *round,* especially a *down round.* If the investor does not so participate, then it suffers specific adverse consequences, including automatic conversion to *common stock* or a "shadow" *preferred stock,* loss of the right to participate in future *rounds,* loss of *anti-dilution protections,* loss of *veto rights,* and loss of *board* representation rights.
Person	In the context of an agreement, often defined to include *corporations*, partnerships, *limited partnerships, LLCs,* and other business entities, as well as groups of the foregoing and individuals.
Piggyback Rights	See *Registration Rights.*
Portfolio Company	A *target* company in which a *venture capital fund* has invested and holds an ownership interest.
Post-Money Value	The value of a *portfolio company* immediately after a funding *round*. The post-money value is the *pre-money value* plus the amount of funds invested in the current round. For example, if investors in the current round invest $10 million in a company that is valued at $15 million pre-money, the resulting post-money value is $25 million.
PPM	Acronym for a *private placement memorandum.*
Preemptive Rights	The right of a stockholder to participate in future issuances of *equity securities* by a company, through the purchase of additional *equity securities,* so as to allow that stockholder to maintain its proportionate ownership interest.
Preferred Return	See *Hurdle Rate.*
Preferred Stock	A class of equity capital ownership of, and a unit of ownership in, a corporation, which (i) may be entitled to dividends (on a *cumulative*

	or *non-cumulative* basis) and (ii) is entitled to a preference or *priority* in payment as compared to *common stock*. This priority may be in respect of the payment of *dividends* or the making of distributions in *liquidation,* or both. Whether through the *certificate of designation* or the *investor rights agreements,* holders of preferred stock typically enjoy various rights and benefits that holders of common stock do not. See also *Convertible Preferred Stock*.
Pre-Money Value	The (agreed-upon, theoretical) value of a company immediately prior to the current investment *round*. This value is determined by negotiation and is calculated (mathematically) by multiplying the number of outstanding (or *fully diluted*) shares before the current round, times the agreed (or derived) purchase price per share in the round. For example, if a *venture capital fund* agrees to invest $5 million in a company with an agreed pre-money value of $10 million and with one million shares outstanding, then the fund would receive 500,000 shares (or shares of *preferred stock* convertible into 500,000 shares of *common stock*) at a purchase price of $10 per share. See also *Post-Money Value*.
Priority	The status of one creditor or security holder having a claim or right (e.g., as to *dividends* or distributions in *liquidation*) that is superior to the claims or rights of another creditor or security holder. The superior claim/right is referred to as *senior,* and the other claim/right is referred to as junior or, in the case of debt, *subordinated*.
Private Equity Fund	A fund typically organized as a *limited partnership* for the purpose of making equity investments in private businesses. Some private equity funds are structured as buyout funds, focused on acquiring all or a controlling equity interest in the *target* business, with the transactions typically financed with

	a substantial amount of senior, subordinated, and sometimes mezzanine financing.
Private Placement; Private Offering	The offer and sale of *securities,* not involving or in connection with a *public offering* and exempt from the *registration* requirements of the *Securities Act.* In short, a way to raise capital from sophisticated (often institutional) investors without registering the offering or the securities with the SEC. Note that even exempt private placement offerings are subject to federal and state *anti-fraud rules* (and may be subject to other state securities laws). See also *Accredited Investor.*
Private Placement Memorandum (PPM)	A disclosure document that sets forth (i) the terms of the *securities* to be offered in a *private placement;* and (ii) a description of the business, operations, product/service, market, competition, ownership, management, and financial condition of the *issuer* (resembling a detailed business plan). Often also includes risk factors and financial projections. Also referred to as a (private) offering memorandum.
Pro Rata	Apportionment based on relative ownership interests (typically, as a percentage of outstanding shares).
Public Offering	A corporation's offer and sale of shares to the public pursuant to a *registration statement* (and prospectus) filed with and declared effective by the SEC under the *Securities Act.* Typically, public offerings are underwritten by one or more investment banking firms, and the shares are listed or quoted on a national securities exchange or stock quotation system. See also *Initial Public Offering.*
Put Option	The right to sell a security at a specified price (or price range) within a specific time period. See also *Call Option* and *Option.*

Qualified IPO; QPO	An *initial public offering* that meets certain contractually defined criteria (e.g., a minimum gross proceeds amount and/or a minimum share price multiple vs. the original investment amount). The criteria is usually designed to ensure a sufficiently robust *IPO* such that the IPO shares will trade on a major securities exchange (e.g., NASDAQ or New York Stock Exchange). The occurrence of a QPO may trigger certain events (*e.g., automatic conversion* of *preferred stock* into *common stock* and/or loss of certain preferred stock holder rights).
Qualified Sale	A sale (or change of control) of a *portfolio company* that meets certain contractually pre-defined criteria (e.g., a minimum gross proceeds or valuation amount, and/or a minimum share price multiple vs. the original investment amount). The criteria is usually designed to produce a sufficiently robust sale to ensure a good return to *preferred stock* holders (in view of their *liquidation preference* and *conversion* and other *rights*). The occurrence of a qualified sale may trigger certain events (e.g., automatic conversion of preferred stock into *common stock* and/or loss of certain preferred stock holder rights).
Redeemable Preferred Stock	*Preferred stock* which, by its terms, enables the stock holder to require that the issuer redeem (or repurchase) the preferred stock for a specific amount within or following a specific time period. The *redemption* feature is also referred to as a *put option* or *put right*.
Redemption	The repurchase (and cancellation) by an *issuer* of its own *securities* from a holder, prior to their maturity (if any), pursuant to the terms of the *securities*. This may be presented as a right or an obligation of the issuer. See also *Forced Buyback*.

Registration	The process under which shares of an *issuer* are registered with the SEC under the *Securities Act* in preparation for a sale of the shares to the public in a *public offering*. As part of this process, the SEC typically reviews and comments on the issuer's *registration statement.*
Registration Rights	Rights of a holder to have securities *registered* with the SEC (on a *registration statement*) in connection with a later *public offering* by the *issuer*. *Demand rights* require (i.e., permit the holder to force) the holder's shares (or a portion thereof) to be so registered. *Piggyback rights* permit the holder to add (or "piggyback") its shares (or a portion thereof) onto another *person's* or the issuer's registration statement (and public offering).
Registration Statement	A detailed disclosure document required by the *Securities Act* (and various related SEC rules), which must be filed with, and ultimately declared effective by, the SEC in order for *securities* to be *registered* and then offered and sold to the public.
Regulation D; Reg D	A series of SEC-adopted rules (under the *Securities Act*) that provide transactional "safe harbor" exemptions for *private placement* transactions from the *registration* requirements of the Securities Act. See also *Private Placement; Private Offering*; and *Accredited Investor*.
Representations and Warranties	Provisions in a *definitive agreement* by which a party makes certain statements of fact as of a specific time, statements which are binding upon it (and for which other parties can pursue remedies in the event of a breach). These factual statements, exceptions to which are set forth in *disclosure schedules,* are often subject to a negotiated *survival period* and accompanied by an *indemnity* obligation from the maker of the statements.

Restricted Shares	Shares of stock acquired in a *private placement;* this stock is considered restricted and may not (absent *registration*) be resold until after an appropriate holding period has expired (or some other available registration exemption is satisfied).
Return on Investment (ROI)	The proceeds yielded from an investment, over a specific time period, calculated as a percentage of (and thus a return on) the original investment.
Revolver; Revolving Facility	A form of *senior debt,* documented through a revolving *credit agreement*. These loans—up to a maximum amount, and subject to the initial and ongoing satisfaction of certain financial and other *covenants* and avoidance of *events of default*—can be borrowed, repaid, and re-borrowed within a specific time period.
Right of First Offer	A provision, typically in a *shareholders' agreement* or *investor rights agreement,* that prohibits a shareholder from selling her/his shares for a defined period unless s/he has first offered to sell the shares to the other shareholders (or to other specified shareholders) at the price and on the terms fixed by the selling shareholder.
Right of First Refusal	A provision, typically in a *shareholders' agreement* or *investor rights agreement*), that prohibits a shareholder from accepting a bona fide offer made by a third *person* to purchase the shareholder's shares unless and until other specified shareholders are first given the opportunity to purchase the shares at the same price and on the same terms.
Road Show	The marketing process during a *public offering* in which the management of an *issuer,* together with the underwriters, meet with groups of prospective investors to stimulate interest in the issuer and the offering.

Round	An investment transaction (or financing event) in which a private company receives funding from outside investors. Venture-backed companies typically receive more than one round of venture capital funding. The term "first-round funding" does not necessarily mean that the company has received no previous outside capital (particularly if from one or more *angel investors*). The first round typically refers to the first investment transaction involving participation by one or more *venture capital funds* or *institutional investors.* See also *"A" Round* and *"B" Round*.
"S" Corporation	A corporation that, by proper and qualifying "election" timely filed with the Internal Revenue Service, does not pay income taxes; instead, like a partnership, its owners/stockholders pay income taxes on their proportion of the corporation's profits at their individual income tax rates. See also *Pass-Through Entity.*
SBIC	Acronym for *Small Business Investment Company.*
Schedule of Exceptions	See *Disclosure Schedule*.
SEC	Acronym for the Securities and Exchange Commission. An independent US regulatory agency responsible for administering and enforcing the federal securities laws, including the Securities Act and the Securities Exchange Act.
Securities Act	Securities Act of 1933, as amended; the federal statute that governs and regulates the offer and sale of *securities*. Also referred to as the 1933 Act.
Securities Exchange Act	The Securities Exchange Act of 1934, as amended; the federal statute that regulates, among other things, the securities markets

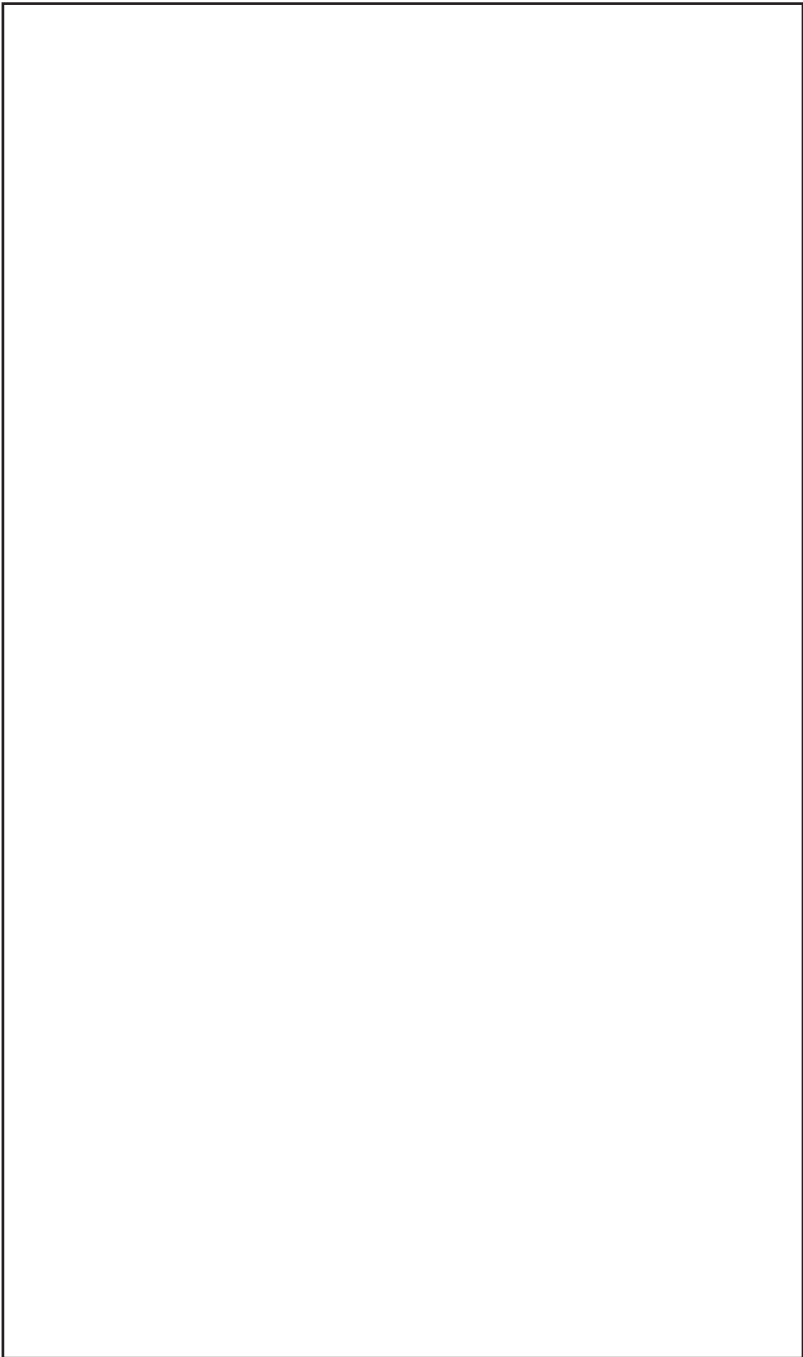
Term	Definition
	and exchanges, periodic reporting (Form 8-K, Form 10-Q, Form 10-K) by public companies, insider trading, proxy solicitations, and tender offers. Also referred to as the 1934 Act.
Security; Securities	Legal instrument(s) that represent(s) an equity or debt interest in an *issuer*. Shares of *capital stock, warrants, options, notes, debentures*, and bonds are examples of securities.
Seed Capital; Seed Financing; Seed Round	Investment capital provided (usually in the first *round)* to a venture in the *start-up* or *seed stage.* Typically funded by *angels, friends and family,* and some *venture capital funds* that focus on seed and *early-stage* financings. The seed round is usually structured as an investment in *common stock* (perhaps including *warrants*) but also may be structured as a loan, convertible loan, or investment in *preferred stock.*
Seed Stage	The initial stage of a business or venture when it has just been organized and its *founders* are developing the venture's business plan, product or service, and initial financing plan. Sometimes also referred to as the *start-up* stage.
Senior	See *Priority.*
Senior Debt	Debt with *priority* in right of payment over junior *(subordinated)* debt, which is generally secured by the assets of the *borrower.* May take the form of a term loan or a *revolving facility,* in each case under a *credit agreement.*
Series A Preferred Stock	See *"A" Round* and *Preferred Stock.*
Shareholders' Agreement	An agreement among the shareholders of a company regulating the governance of the company, the ownership and transfer of its *equity securities,* and other matters. Often contains provisions relating to *preemptive*

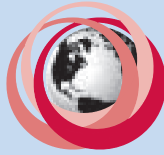
	rights, drag-along rights, tag-along rights, rights of first offer/refusal, and *veto rights.*
Shell	An entity with no significant assets, business, or operations.
Small Business Investment Company (SBIC)	An investment firm licensed by the US Small Business Administration (SBA) to obtain matching federal loans for its venture capital/private equity investments. An SBIC will generally have access to $2 in credit (in the form of low-interest-rate loans, drawn down on a deal-by-deal basis) for every $1 that it invests in a *portfolio company* meeting certain requirements.
Staged Investing	An investment in a company structured to be funded in stages (or installments), with the initial installment at the first *closing* and then subsequent installments if the company meets certain specified milestones (e.g., hiring key managers, reaching a revenue hurdle, meeting project development deadlines, landing a specified number of customers) or if an agreed time period lapses. Also referred to as *milestone-based investing*.
Start-up	A company or business in its formative or *seed stage*.
Stock Option	See *Option, Incentive Stock Options,* and *Non-Qualified Stock Options*.
Stock Pool	See *Option Pool.*
Strategic Investors	Corporate or individual investors that add strategic value to their equity investments through industry experience, expertise, and contacts. These investors can assist companies in operations, finance, marketing, sales, intellectual property, acquisitions and other disciplines, as well as in raising additional capital and effecting *exit strategies*.
Subordinated	Inferior in right of payment or other rights (typically applied to debt). See also *Priority.*

Subordinated Debt	Debt that is *subordinated* (and thus inferior) in right of payment to other more senior debt in the event of *liquidation*, insolvency, or bankruptcy. Subordinated debt is sometimes also called "high-yield debt" (given the high interest rate it bears).
Survival; **Survival Period;** **Survive**	*Representations and warranties* and *covenants* in a *definitive agreement* that, by their terms, continue to operate and that, if breached, may serve as the basis of an *indemnity* claim after the *closing* are said to "survive" the closing. The period during which such representations and warranties and covenants continue to operate (and serve as the basis of an indemnity claim) post-closing is referred to as the survival period. Thus, the survival period operates as a contractually specified statute of limitations.
Sweat Equity	Equity ownership received (typically, by *founders,* employees, and consultants) as a result of and in exchange for work, deliverables, or expertise (the "sweat"), as opposed to a cash investment.
Tag-Along Rights	Contractual right of a minority investor/shareholder (typically provided in a *shareholders' agreement*) to sell its stock (on a *pro rata* basis) along with and at the same price as the *founder* or majority shareholder, if either the founder or majority shareholder elects to sell stock to a third party. In this way, the minority investor/shareholder is permitted to "tag along" with the selling shareholders. Also referred to as *co-sale rights*.
Target	The recipient of funding in an investment transaction. For example, in a typical venture capital transaction, the target is the *issuer* of the *preferred stock;* upon the *closing*, the target becomes a *portfolio company* of the investing *venture capital fund* or funds. The word also refers to a company or business

	entity being acquired in an acquisition transaction.
Ten Bagger	An investment that returns to its investors (at least) 10 times the initial amount of capital invested.
Term Sheet	An abbreviated, high-level written summary (sometimes in list or bullet-point format) of the material terms of a potential investment transaction and serving as the basis for preparing one or more *definitive agreements.* See also *Letter of Intent.*
Underwater	The state of being "out of the money." An *option* or *warrant* is underwater if the current fair market value of the underlying stock is less than the option or warrant *exercise price*.
Venture Capital Fund	A fund typically organized as a *limited partnership* for the purpose of making equity investments in private businesses believed to have exceptional growth potential (and the promise of yielding super-sized returns on the fund's capital).
Veto Rights	Rights granted to certain shareholders (or to some or all of a class or series of shares) to vote on or approve certain specified actions or transactions by an *issuer* (e.g., additional equity financings, borrowings or capital expenditures over a specified amount, an *IPO*, transactions with affiliates, sale or other change of control). Thus, without the vote or consent of the shareholders holding these rights, the action in question may be vetoed or blocked. Veto rights are one type of *minority protection*. Also often referred to as *blocking rights*.
Voting Stock	Stock giving the holder the right to vote for the election of the *issuer's* board of directors generally (and not just upon the occurrence of certain events, such as the failure to pay *dividends* or breach of a *covenant*).

Warrant	A security that provides the holder with the right to purchase stock *(equity securities)* at a specified price (referred to as the *exercise price*) within or over a specified time period. Similar to an *option,* but typically issued to third parties (not directors, employees, or insiders) in connection with the issuance of *debt securities*.
Washout Round	A financing *round* whereby previous investors, *founders,* and management/employees suffer substantial *dilution* (and loss of rights). As a result of a washout round, the new investors usually gain majority ownership and control of the *issuer*.
Weighted Average Ratchet	A type of *anti-dilution provision,* which applies a weighted average formula to adjust the *exercise price* or *conversion ratio* of a security downward based on the sale price and number of common equivalent shares issued by the company (in a subsequent *down round*) after the issuance of the first security. The *broad-based weighted average ratchet* is the most commonly used anti-dilution formulation in venture capital transactions. In essence, the effect of the share issuance in the down round is spread over a large number or broad base of shares (all *fully diluted* outstanding shares, including unexercised options and outstanding convertible securities). In a *narrow-based weighted average ratchet* (a protection more favorable to the investor), the effect of the share issuance in the down round is spread over a smaller number or base of shares (e.g., issued and outstanding shares only).





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