Negotiating Venture-Capital Transactions

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The term "venture capital" refers generally to relatively high-risk, early-stage financing of young, emerging growth companies. The professional venture capitalist is usually a highly trained finance professional who manages a pool of venture funds for investment in growing companies on behalf of a group of passive investors. Another major source of venture capital for growing companies is the Small Business Investment Company (SBIC), a privately organized investment firm specially licensed under the Small Business Investment Act of 1958 to borrow funds through the Small Business Administration, for subsequent investment in the small business community. Private corporations and state governments also manage venture funds for investment in growth companies.

Regardless of your company's particular stage of development, primary products and services or geographic location, all venture capital firms will consider several key variables in analyzing your business plan before committing capital to the project. To show that your company qualifies for venture capital, your management team must be prepared to answer the following questions:

- *Management Team*. What are the background, knowledge, skills and abilities of each member? How is this experience relevant to the specific industry in which the company competes? How are the risks and problems that are inherent to your industry handled by the members of the management team?

- *Products and Services*. What stage of development has the company's products and services reached? What is the specific market opportunity your company has identified? How long will this "window of opportunity" remain open? What steps are necessary to exploit it? To what extent are your company's products and services unique, innovative and proprietary?

- *Targeted Markets*. At what stage in the life-cycle of the industry does your company plan to operate? What is the size and projected growth rate of the company's targeted market? What methods of marketing, sales and distribution will be utilized to attract and keep customers? What are each competitor's strengths and weaknesses (direct, indirect or anticipated) in the targeted market?

- *Return on Investment*. What are your company's current and projected valuation and performance in terms of sales, earnings and dividends? To what extent have these budgets and projections been substantiated? Has the company overestimated or underestimated the amount of capital required for the growth and development of its business plan? How much money and time have already been invested by the owners and managers?

Negotiating and Structuring the Agreement

Once a financing proposal is favorably received, the company must assemble a negotiation team. The negotiation and structuring of most venture-capital transactions revolves around the need to strike a balance between the concerns of the founders (such as dilution of ownership and loss of control) and the concerns of the venture capitalist (such as return on

investment and mitigating the risk of company failure). The typical end result of these discussions is a Term Sheet that specifies the key financial and legal terms of the transaction and serves as a basis for the negotiation and preparation of the definitive legal documentation. Your company's attorney should be familiar with the many traps and restrictions that are typically found in venture-capital financing documents.

The Term Sheet may also lay out certain rights and obligations of the parties, including obligations to maintain an agreed company valuation, be responsible for certain costs and expenses in the event the proposed transaction does not take place or secure commitments for financing from additional sources prior to closing. Often these obligations will also be included as part of the "conditions precedent" section of the formal Investment Agreement.

Negotiation regarding the structure of the transaction usually centers on the types of securities to be used and the principal terms, conditions and benefits they offer. Securities usually fall within one of the following categories:

- *Preferred stock* is the most typical form of security issued in connection with venture-capital financing because of the many advantages it offers to an investor (such as convertibility into common stock, dividend and liquidation preferences over common stock, anti-dilution protection, mandatory or optional redemption schedules and special voting rights and preferences).

- *Convertible debentures* are often preferred by venture capitalists in connection with higher-risk transactions because holders of these securities enjoy the elevated position of creditors until the risk of the company's failure has been mitigated.

- *Debt securities with warrants* (preferred by venture capitalists for the same reasons as convertible debt) allows holders to protect downside by giving them the elevated position of a creditor and the ability to protect upside by including warrants to purchase common stock at favorable prices and terms. The use of a warrant enables the investor to buy common stock without sacrificing the creditor position.

- *Common stock* is rarely preferred by venture capitalists (especially at early stages of development) because it does not offer the investor any special rights or preferences, a fixed return on investment, special ability to exercise control over management or liquidity to protect against downside risks. One of the few times that common stock might be selected is when the company wishes to preserve its Subchapter S status under the Internal Revenue Code.

Once the type of security is selected, steps must be taken to ensure that it is properly authorized and issued under applicable state corporate laws. For example, if the company's charter does not provide for a class of preferred stock, then articles of amendment must be prepared, approved by the board of directors and shareholders and filed with the appropriate state corporation authorities. The articles of amendment will be the focus of negotiation on voting rights, dividend rates and preferences, mandatory redemption provisions, anti-dilution protection (also called "ratchet clauses") and related special rights and features. If debentures are selected, then negotiations will typically focus on term, interest rate and payment schedule, conversion rights and rates, extent of subordination, remedies for default, acceleration and pre-payment rights and underlying security for the instrument, as well as the terms and conditions of any warrants that are granted along with the debentures.

Legal Documents

The legal documents involved in venture-capital financing reflect the end-result of the negotiation process and must contain all the legal rights and obligations to which the parties have agreed. These documents generally include the preferred stock or debenture purchase agreement (Investment Agreement), the stockholders' agreement, the employment and confidentiality agreements, the warrant (where applicable), debentures or notes (where applicable), a Preferred Stock Resolution to amend the corporate charter (where applicable), a Contingent Proxy, the legal opinion of company counsel and the Registration Rights Agreement.

The *Investment Agreement* describes all material terms and conditions of the financing. It also serves as a type of disclosure document because certain key historical and financial information is disclosed in the representations and warranties made to the investors. These (along with any exhibits) then provide a basis for evaluating the risk of the investment and structure of the transaction.

The Investment Agreement also provides for certain conditions precedent, which must be met by the company prior to the closing. Such provisions require the company to perform certain acts at (or prior to) closing as a condition of obtaining the financing. The conditions are often used in negotiations to mitigate or eliminate certain risks identified by the investor (such as a class-action suit by a group of disgruntled employees) but are usually more of an administrative checklist of actions that must be taken at closing, such as the execution of the stockholders', employment and confidentiality agreements.

The *Stockholders' Agreement* usually contains certain restrictions on the transfer of the company's securities, voting provisions, rights of first refusal, and co-sale rights in the event of a sale of the founder's securities, anti-dilution rights and optional redemption rights for the venture-capital investors. Venture capitalists often require the principal stockholders to become parties to the stockholders' agreement as a condition to closing on the investment.

Any existing stockholders' or buy/sell agreements will also be carefully scrutinized and may need to be amended or terminated as a condition to the investment. For example, the investors may want to reserve a right to purchase additional shares of preferred stock (in order to preserve their respective equity ownership stakes in the event that another round of the preferred stock is subsequently issued). This is often accomplished with a contractual pre-emptive right (instead of putting such a right into the corporate charter, which would make it available to all holders of the company's stock).

Employment and Confidentiality Agreements are often required of key members of the management team as a condition of obtaining the investment. These agreements define each executive's obligations, compensation package, grounds for termination and obligation to preserve and protect the company's intellectual property, as well as any post-termination covenants (such as not to compete or disclose confidential information).

A *Contingent Proxy* provides for a transfer to the venture capitalist of the voting rights attached to any securities held by a key principal upon the death or disability of that individual. The proxy may also be used as a penalty for breach of a covenant or warranty included in the Investment Agreement.

A *Registration Rights Agreement* obliges venture-capital investors to convert their preferred stock or debentures prior to the time when a registration statement is approved by the SEC. It is often required, since these registration rights are limited to the company's common stock. Many venture capitalists view the eventual public offering of the company's securities (pursuant to a registration statement filed with the SEC under the Securities Act) as the optimal method of achieving investment liquidity and maximum return on investment. As a result, the venture capitalist will protect his or her right to participate in the IPO with a Registration Rights Agreement.

The registration rights may be in the form of "demand rights" (which are the investors' right to require the company to prepare, file and maintain a registration statement) or "piggyback rights" (which allow the investors to have their investment securities included in a company-initiated registration). The number of each type of demand or piggyback rights, the percentage of investors necessary to exercise these rights, the allocation of registration expenses, the minimum size of the offering, the scope of indemnification and the selection of underwriters and broker/dealers are all areas to be negotiated in the Registration Rights Agreement.

A well-prepared business plan, an understanding of the analysis conducted by venture capitalists and awareness regarding the legal documents prepared for a venture-capital transaction will significantly increase your company's ability to gain access to this type of financing.