Venture Capital for High Technology Companies

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Introduction

Founding your own high-growth, high technology company, financing it with venture capital and successfully bringing a product to market is a challenging experience. Entrepreneurs are dynamic people, motivated by their vision of a unique product concept and the drive to make that product a successful reality. Because founding a successful high tech company is so different from working in a large company, many new entrepreneurs are unfamiliar with the legal issues involved in creating a high tech start-up.

This booklet introduces new entrepreneurs to a variety of legal and strategic issues relating to founding and financing a start-up company, including determining your product and market, assembling the right founding team, choosing your legal structure, making initial stock issuances to founders, obtaining seed financing, negotiating the terms of your venture financing and the pros and cons of being acquired or taking your company public.

At the end of the booklet, we provide two Appendices. The first Appendix offers a set of financing scenarios that illustrate typical amounts of venture capital raised, company valuations at different stages of a company's existence and how ownership changes over time — first with a company that is successful and second with a company that undergoes a "down round" of financing. The second Appendix is a sample Series B Preferred Stock Term Sheet, illustrating the type of provisions you might see requested by a venture capitalist.

Of course, no two companies are identical and, accordingly, not all issues encountered are discussed, nor will every start-up face all of the issues discussed below. However, they are typical of the start-up companies Fenwick represents.

The following are other available Fenwick booklets:

- Acquiring and Protecting Technology: The Intellectual Property Audit
- Annual Update: International Legal Protection for Software
- Copyright Protection for High Technology Companies
- Corporate Partnering for High Technology Companies
- International Distribution for High Technology Companies
- Mergers and Acquisitions for High Technology Companies
- Patent Protection for High Technology Companies
- Patent Licensing for High Technology Companies
- Structuring Effective Earnouts
- Trademark Selection and Protection for High Technology Companies
- Trade Secrecy: A Practical Guide for High Technology Companies

Typical Start-Up Questions

What is "vesting"? "Vesting" requires founders to earn their stock over time. The company retains aright to buy back unvested stock at the original purchase price on termination of employment. In contrast to founders stock, stock options typically become exercisable as they vest.

Why do I want vesting? Vesting protects founders who remain with the company from an ex-founder becoming wealthy on their efforts if that ex-founder quits before he or she has earned his or her stock. Venture capitalists require vesting as a condition to funding your company.

How do I avoid tax liability on the receipt or vesting of founders' stock? Incorporate early and issue founders' stock at a low price to the founding team before you bring in outside investors. File your 83(b) election with the IRS within 30 days of purchase.

How are venture financings structured? Companies sell convertible preferred stock to outside investors. Employees continue to buy common stock at a fraction of the price paid by the outside investors. The price differential starts at 10 to 1 and then declines as the company nears an IPO or acquisition.

What do I have to give away in negotiations with venture capitalists? Typical deals include basic preferred stock liquidation and dividend preferences, weighted average antidilution protection and registration rights. You'll also have to agree to certain restrictions on how you run your company. Actual terms will vary depending on the quality of your company and the current financing environment.

What should I try to avoid in negotiations with venture capitalists? Avoid ratchet antidilution protection, mandatory redemption, redemption premiums, super liquidation preferences and excessive restrictions on how you run your company.

How do I protect my technology? Use nondisclosure and assignment of invention agreements and consider patent, trademark, trade secret and copyright protection at an early stage.

How do I choose a lawyer? Choose one with substantial start-up experience working with your type of business. It is also helpful if the lawyer's firm has the intellectual property, corporate and securities laws, domestic and international tax and litigation expertise that your company will need as it grows.

Threshold Issues When Starting Your Business

Identifying a Market Need

The first step in starting your new business venture is to identify a market need and the product or service that will meet that need. Too often, high tech products and businesses are launched because the founders become fascinated by their new technology without first determining whether the technological advance will cost-effectively meet customers' needs. Your products and services should be defined and shaped in response to real problems being experienced by real customers. In tough markets, you may have to show customer acceptance of your product or revenue in order to raise venture capital or angel funding.

Product Definition

You must determine the competitive edge that will make your proposed product preferable to comparable products currently used in the target market. Will your product accomplish the job faster, or be easier to use, more reliable and cheaper to produce or service? Will these advantages be long- or short-term? Critically evaluate your plan to ensure that your technological advances will provide cost-effective and reliable solutions to the customer's problem or fill new market requirements and will allow your company to become profitable.

Market Evaluation

Once you have defined your product in terms of a market need, you should evaluate that market. What types of customers will need the benefits your product offers over competing products? Is it a product that will be used by individuals, by small businesses, by Fortune 500 companies, by the government or by foreign customers? The customer base frequently dictates the distribution channels best used to reach your customers. A direct sales force may be required to reach the Fortune 500 market, while a low-priced consumer product generally will be sold through retail distribution or for end-use software via Internet downloads. How large is the market today and how large will it be in five years? A large and growing potential market is essential to obtaining venture capital. Most venture capitalists look for companies that can become profitable and attain at least $100 million a year in revenues in the next 10 years (possibly longer for bioscience companies). Knowing your customer base is a prerequisite to knowing what skills, experience base and connections you will need from your founding team and advisors.

Capital Needs

Once you have assessed your product and its market, you should determine the capital needed to fund its development and commercial exploitation. To avoid excessive dilution, the best approach is to stage the capital raised by development milestones, making sure that you raise enough money at each stage to attain your milestone with some cushion. Milestones met reduce investment risk and increase the company's valuation. Milestones missed increase investment risk and reduce the company's valuation. You also need to evaluate how quickly you want to grow the company and what capital would be needed for

slow and fast growth scenarios. Finally, consider currently available sources of capital and their expected financing terms and rates of return on their investment. Your company's capital needs will be a fundamental issue for investors, and should be presented clearly in the company's business plan.

Recruiting Your Team

Composition of the Team

After you have defined the product, its market and the skills needed to bring the product to market, the next step is to put together a founding team. The people you select to make up the founding team are vital to the success of the company. While you may not be comfortable with sharing control of ideas and profits with others, your success will depend on recognizing your strengths and weaknesses early on and recruiting people with skills to complement your own. Ideally, a well-rounded founding team should include the following key managers:

- Chief Executive Officer
- Vice President of Research and Development
- Vice President(s) of Sales and/or Marketing
- Chief Financial Officer/VP Administration

Quality Leadership

You may not be able to recruit all the members of your founding team at once. Take time to recruit the best possible people who are experienced at doing the things your business will need to succeed. Be realistic about your own skills. If you have not had direct experience in managing and growing an organization, recruit a strong CEO who knows how to build a company and translates ideas into successful products. Your ability to obtain funding and the ultimate success of your business depends on the excellence of the people you recruit for your founding team.

Inexperienced key managers in a start-up are more likely to fail and need to be replaced as the company grows. Hiring key replacements is disruptive to your organization and will result in additional dilution of the ownership interests of the original founders. The percentage of the company that the founders will be able to retain is a direct function of their ability to handle key management roles well throughout the company's growth. The financing scenario at the end of this booklet, which shows the founders retaining 22 percent of the company's stock at the initial public offering, assumes a strong founding team in a company needing relatively little outside capital. A weaker team or one that requires larger capital infusions could retain less than 3-5 percent of the company's equity by the initial public offering.

Board of Directors

In addition to recruiting your founding team, you will need to recruit people to serve on your company's board of directors. The board of directors is the governing body of the

corporation, owing fiduciary duties to all shareholders. It elects the company's officers and approves all major decisions. The board takes action by majority vote.

As a result, a founder-CEO-director, who owns a majority of the shares, can still be outvoted on the board on such important matters as sales of additional stock and the election of officers. Thus, careful selection of an initial board is essential. You want board members whose judgment you trust (even if they disagree with you) and who can provide you with input and resources not available from your management team. You might also consider recruiting industry experts to serve on an advisory board to assist you with technology and marketing issues.

Legal Structure

The next step is selecting the legal structure for your company. You have a choice among the following structures:

- Proprietorship
- Partnership or LLC
- Corporation
- S Corporation

Although most high tech companies are corporations, it is sometimes preferable to organize your business as a proprietorship or partnership. Before choosing your legal structure, consult with legal and accounting advisors. The following summary can help you select the right structure for your business.

Proprietorship

A proprietorship is simple. You own your own business. You and your business are considered one and the same — there is no legal distinction. All income received by the business is taxable to the individual proprietor, and the proprietor has unlimited liability for all obligations and debts of the business. Although this structure is not recommended for high-growth companies, it may be beneficial for inventors who wish to license their technology for royalties. Typically, an inventor will pay far less income tax as a proprietorship than as a corporation.

Partnership

In a partnership, two or more people operate a business together and divide the profits.

General Partnership: In a general partnership, any partner can bind all other partners for actions within the scope of the partnership's business. All partners have equal management rights and unlimited liability for partnership obligations.

Limited Partnership: In a limited partnership, there are two types of partners, passive and active. The passive or limited partners have no say in day-to-day management. Their liability,

like that of shareholders in a corporation, is limited to their investment in the partnership. The active or general partners act as they would in a general partnership.

In both types of partnerships, profits and losses can be allocated among the partners in varying ways and are taxable to the partners when recognized by the partnership. The ability to allocate initial losses to limited partners, within IRS limits, makes partnerships attractive for financing tax-advantaged research and development transactions. While investors in a corporation generally cannot deduct money invested until the stock is sold or becomes worthless, partners can currently deduct their share of a partnership's losses. Limited liability companies (LLCs) are similar to limited partnerships, but are typically inappropriate for fast growth companies since, unlike corporations, they do not easily accommodate employee option plans and a corporation cannot do a tax-deferred acquisition of an LLC.

Corporation

The most common structure used by high tech companies is the corporation.

A corporation is a legal entity that is separate from the people who own and operate it. The shareholders own the corporation and elect a Board of Directors. The Board of Directors governs the corporation and appoints the officers who manage its day-to-day business.

A corporation pays income tax on its income, while its shareholders generally pay income tax only on dividends received. Shareholder liability for corporate obligations is generally limited to their investment in their shares.

One advantage of a corporation is that it can have different classes of stock with different rights. In addition to common stock, it can create and sell preferred stock, having preferences over the common stock. The preferences justify selling common stock to employees who provide "sweat equity" in the business at a substantial discount from the price paid by outside investors for the preferred stock. If your company will need substantial capital, intends to grow rapidly and/or will have substantial numbers of employees requiring equity incentives, you should probably incorporate.

S Corporation

If you won't seek venture capital immediately, but want a corporate structure, you should consider electing to be treated as an S corporation. An S corporation is treated much like a partnership for tax purposes. Corporate income and losses will pass through to the shareholders, enabling the founders to offset their other personal income with the corporation's initial losses.

There are strict rules regarding S corporations. An S corporation can have only one class of outstanding shares and no more than 75 shareholders. Shareholders must be U.S. resident individuals or trusts (not partnerships or corporations). These rules make it impractical for

most high-growth start-ups to remain S corporations. For example, upon the sale of common stock to a corporate investor or a venture capital partnership or the sale of preferred stock to any investor, S corporation status will automatically be lost. You can, however, start as an S corporation and later elect to be treated as a C (or normal) corporation.

Initial Stock Issuances to the Founders

If you select the corporation as your form of business entity, the next step is to incorporate the company and issue stock to the founders. You will need to consider stock valuation, income tax considerations, vesting and buy-back rights, the availability of seed financing and compliance with securities laws.

How do You Value Founders' Stock?

It is often difficult to estimate the value of a start-up since it has no business or earnings history. Typically, there is no readily ascertainable value for the stock issued, so founders' stock is usually issued at a nominal price, such as $0.001 per share, paid in cash. However, if you or other founders contribute property or rights to previously existing technology or inventions, you must value the property contributed in exchange for the stock.

It is important to make founders' stock issuances as early as possible to avoid potential adverse income tax consequences. If stock is issued to employees at a low price at the same time that it is issued to outside investors at a higher price, the IRS will treat the difference between the two prices as taxable compensation to the employee.

How do Founders Avoid Income Tax Liability?

There are several ways to avoid income tax on founders' shares when selling equity to other investors.

- Issue the founders' stock early and allow time to pass before issuing stock to outside investors at a higher price.
- Create value in your company between the issuance of founders' stock and issuances to investors. You can create such value by writing a business plan, creating a product prototype or signing a letter of intent with a prospective customer.
- Create a two-tiered capital structure of common and preferred stock. Preferred stock preferences justify charging outside investors a higher price than employees who purchase common stock.

Vesting Schedules and Buy-Back Rights

Because founders buy their initial equity at a nominal price, they should "earn" their stock over a "vesting" period based on their continued service to the company. A typical vesting arrangement would provide that shares vest over four years, with no shares vesting in the first year of employment, 25 percent of the shares vesting at the end of that year, with two percent of the shares vesting monthly thereafter. Since there is a risk of job loss in an

acquisition, some vesting arrangements accelerate the founders' vesting by 12 months or more if the company is acquired.

Your company should retain the right to repurchase an employee's unvested shares at the original purchase price on termination of employment. A minority of companies also retain the right to repurchase vested shares on termination of employment at the then-current fair market value of the company's stock although that has adverse accounting implications. In addition, most private companies retain a right of first refusal on shareholder resales of their stock, primarily to keep stock from falling into unfriendly hands.

Why Have Vesting and Buy-Back Rights?

Vesting is important, even though many founders dislike it. Best intentions notwithstanding, all the original members of a founding team may not remain with the company. Some conflict may arise causing one or more team members to leave the venture. If this happens in a company without vesting, enormous resentment results towards the ex-founders who keep their stock and "free-ride" on the efforts of those who continue to build the company.

With vesting and buy-back provisions, an ex-founder is allowed to keep only those shares that vested during his or her tenure. This is more fair and reflects the ex-founder's actual contribution to the company's success.

On a more pragmatic note, if you and the other founders do not impose vesting, the venture capitalists will. Since venture capitalists generally bring the first substantial capital to most start-ups, they will insist that the founders earn the value contributed by the financing over a standard-vesting period before they invest.

What is an 83(b) Election?

Whenever your company reserves the right to buy back stock at the original purchase price on termination of your employment, you should consider filing a Section 83(b) election with the IRS. By filing this election, you, as the purchaser, are electing to be taxed immediately on the difference between the fair market value of the stock and the price you paid for it. If you paid fair market value for the stock, then you will not pay any taxes as a result of the election.

If you do not file a Section 83(b) election within 30 days of your stock purchase, you will be taxed on each vesting date on the difference between the fair market value of the shares vesting on that date and the price paid for them. That difference could be substantial if the company's stock value substantially appreciates, and the tax may be payable before the shares can be sold.

How do you Protect Your Company's Technology?

Next to your people, your company's inventions and technology may be its most precious assets. A few simple steps are necessary to protect that technology. If the founders have

developed technology prior to incorporating the company, have them assign the intellectual property rights to the company. From the very beginning, all company employees should sign the company's standard form of confidentiality and assignment of inventions agreement. Have third parties sign a nondisclosure agreement before giving them access to your confidential technology. Consult competent intellectual property counsel to find out if your technology qualifies for copyright or patent protection. Rights can be lost if notice and filing requirements are not met in a timely fashion. Consult trademark counsel before you select your company, product and domain names to find out if they infringe someone else's trademarks and to take the steps necessary to obtain exclusive rights to those names. (See the Fenwick booklets on Copyright, Trade Secrecy, Trademark and Patent Protection for a detailed discussion of these issues.)

Preparing a Business Plan

A business plan is an excellent tool for planning your business and assessing your performance. It also can help sell your company to potential investors. The time invested in developing a good business plan will have major long-term returns.

The business plan should be no more than 25 to 30 pages long. It should be prefaced by a two-page "executive summary" highlighting the following topics that should be set forth in greater detail in the actual business plan:

- Company description, location, and history;
- Product(s) to be developed and underlying technology;
- Size and growth rate of the market;
- Competition;
- Company's competitive advantage;
- Management team;
- Financial summary of projected revenues and income, balance sheets and cash flow statements for five years, with monthly detail for the first two years and
- Amount and structure of the proposed financing.

The bulk of the business plan should focus on the issues the venture capitalists are most interested in: the size and growth rate of the market, your targeted customers, competitors and your competitive advantage and the background of the management team. The business plan should not be a technical treatise on product development or market analysis. You should address these issues, of course, but it is preferable to compile an appendix to the business plan containing that information to be provided to investors who show serious interest. If you have never written a business plan, consult some of the detailed materials provided by many major accounting firms. Before presenting it to the venture capitalists, have it reviewed by counsel experienced in venture capital investments.

Seed Financing

What is Seed Financing?

Some founding teams with strong track records can raise venture capital without a business plan or a product prototype. Most people, however, find it necessary to seek a small amount of "seed" money from friends, relatives, angels or "seed round" venture capitalists. This seed money is used to support the fledgling company while a business plan is written or a product prototype is developed.

Where can you Find Seed Money?

Obtaining capital from outside investors during the early stages of your company's development may be difficult. Since only small amounts of money are usually required at this early stage, friends and family may be a realistic source of seed money. Accept money only from those who are sophisticated enough to understand the risk and who can afford to lose their investment. Doing so helps you comply with securities laws and maintain good relations if your company does not succeed.

Few start-ups can obtain seed money from the venture capital community. For an as yet unproven start-up, it can take six to eighteen months to build venture capital contacts, educate them about your product idea and convince them of the strength of your founding team.

Given these difficulties, it may be better for your start-up to try to attract "angels" or "advisory investors," such as a successful entrepreneur with self-generated wealth in a related industry. This type of investor will understand the merits and weaknesses of your business idea. More important still, these investors can be invaluable in helping you pull together the company and in introducing you to the venture community.

Compliance with Securities Laws

Although your company's initial resources will probably be limited, you must comply with federal and state securities laws when issuing stock or granting employee stock options. At a minimum, noncompliance gives purchasers a rescission right that can compel your company to refund the entire purchase price of the stock. You and your company might also be subject to fines and criminal liability. Meeting the legal requirements is not necessarily expensive if you have competent legal counsel to advise you before you offer to sell the stock. Exemptions from the costly process of registration with the Securities and Exchange Commission (SEC) will usually be available if you are careful in selecting the investors to whom you offer the securities and in making the offer. Filings with federal and state securities agencies may also be required.

What do the Venture Capitalists Want?
Most venture capitalists are looking for a company that can be profitable and grow to at least $100 million or more in revenues in 10 years (possibly more for bioscience companies). They are looking for large and growing markets where there is a demonstrable need for the product the company plans to develop. Many venture capitalists say that they would rather take a technology risk (can the product be developed?) than a market risk (will people want the product?). Technology risks are generally eliminated earlier when the capital needed and the company's valuation are less, while market risks will not be eliminated until after the product has been completed and introduced into the market. Venture capitalists also tend to "invest in people" rather than in ideas or technologies. Hence the strength of the management team is the most crucial element in raising money.

Financing—the First Round

How Should you Select a Venture Capitalist?
Selecting the right venture capitalist is as important as picking the right founding team. Take the time to talk to the venture capitalist to ensure that you can work well together. Look for someone who knows your industry. An ideal candidate would be someone who knows your product or market and is located close enough to your company to be available when you need help. It is also important as you launch your business to get people who have the depth and breadth of experience that you may initially lack.

If chosen correctly, venture capitalists can provide a wealth of information on management techniques, problem solving and industry contacts. They also can offer a broader perspective on your product's market fit, as well as additional funding as your company grows.

If, on the other hand, a venture capitalist is incorrectly chosen, you may find that the capital invested is tied to needless operating restrictions and monthly headaches at board meetings where you will regularly be asked why you are not "on plan." Where funding is available from several venture firms, ask the CEOs of their portfolio companies about their experience with the respective venture capitalists.

How do you Find Venture Capitalists?
There are many sources of basic information about venture capital firms. Some of the published sources include Pratt's Guide to Venture Capital Sources and the Directory of the Western Association of Venture Capitalists. Venture One has the best database on venture capitalists and the companies they fund. Through it you can find out which venture capital firms invested in similar companies and which partners of those firms sit on their Boards of Directors. While this database is not available to the public, most major law firms with a startup focus have licenses to it.

The best way for you to meet venture capital investors is to be introduced to them through successful entrepreneurs who have been funded by them. Other good sources include lawyers, accountants and bankers who focus in working with high tech companies. If at all possible, make sure that you are introduced or have your business plan forwarded to the venture capitalist by one of these people. While your business plan has to stand on its own merits, an introduction from a credible source can ensure it more than a cursory review and can result in useful feedback if the venture capitalist decides not to invest.

How Much Money Should you Raise?

In the first round of venture capital financing, you should try to raise a sufficient amount of capital to fund product development. The business plan usually will set a demonstrable risk-reducing milestone, such as having a working product ready for production. Given the seemingly inevitable delays in product development and the time it takes to arrange the next round of financing (at least two to six months), you should build some cushion into the amount you raise.

How Much is Your Company Worth?

Determining the value of your company at this early stage is more of a "mystic art" than a calculated formula. In theory, investors attempt to estimate the value of the company at some time in the future (say 10 to 20 times earnings in year five). They then discount that value to a present value with a desired rate of return. If the investor is looking for a tenfold return in five years and the company is expected to be worth $50 million in five years, it may be worth $5 million today.

In practice, however, venture capitalists seem to estimate the amount of cash required to achieve some development milestone and, often without regard to how much that is, equate that amount to 50 to 60 percent of the company (fully diluted for employee shares — see Employee Stock Plans below). The best way to find out how your company is likely to be valued is to look at what valuations venture capitalists are giving to other companies at the same development stage and in the same general market area.

Venture Capitalists will give your company a "pre-money" valuation based on its stage of development. Your pre-money valuation is the price per share that they are offering you times all of the outstanding stock, options and pool reserved for future employees. When discussing a pre-money valuation, remember to clarify the size of pool contemplated by the venture capitalists. Adequate shares for one year is typical. After the venture funding, your "post money" valuation is easy to determine. Just multiply the fully diluted outstanding capital of your company by the price per share paid by the last round investors.

The Structure of a Typical Venture Financing

Why Have Preferred Stock?

Companies typically sell convertible preferred stock to venture investors at a substantial premium over the price charged to the founders or the seed investors. At a minimum, the preferred stock gives the investors a liquidation preference in the event the company fails or is acquired. In addition, they usually obtain certain other preferential rights over the holders of common stock. From your company's point of view, these preferences justify a fair market value differential between the preferred stock and the common stock. This enables your company to continue to sell common stock to your employees at a lower price than is paid by the preferred investors.

Typical Preferred Stock Preferences

There are six basic types of preferences granted to preferred stock.

Liquidation Preference. Upon liquidation of the company, the preferred stock has the right to receive a fixed-dollar amount before any assets can be distributed to the holders of common stock. Typically, the liquidation preference is the purchase price plus accrued but unpaid dividends. A "participating" preferred stock also participates with the common stock in the distribution of any assets left after payment of the liquidation preference. In addition to actual liquidations, venture capitalists also want to receive their liquidation preference on a company merger. This provision will give the preferred shareholders the right to receive at least their original investment back in the event of a merger and sometimes a multiple return on their money before the common shareholders will participate.

Dividend Preference. Most preferred stock is given a dividend preference over the common stock. There are two types of dividend preferences. A "when, as and if declared, noncumulative" dividend preference means that the company cannot declare dividends on the common stock until a specified dividend is paid on the preferred stock. By contrast, a "mandatory, cumulative" dividend preference is more like an interest provision, since it requires the company to set aside and pay dividends on the preferred stock at a designated rate. Most high tech companies do not pay dividends, and by agreeing to mandatory, cumula-tive dividends you may adversely affect your company's cash flow and put it at a competitive disadvantage. Mandatory dividends are not frequently used, but if they are, it is usually in conjunction with mandatory redemption by investors.

Redemption. There are two kinds of redemption provisions. An "optional" redemption provision lets the company repurchase or redeem the preferred stock at its purchase price plus a redemption premium. The company can thus force the preferred stock to convert to common stock or face redemption. A "mandatory" redemption provision lets the investors require the company to repurchase the investors' preferred stock at its purchase price plus a redemption premium. Investors may want the right to recover their initial investment, plus a

profit, if the company fails to meet expectations. Companies dislike mandatory redemption because the investment is more like debt than equity. Under current tax rules, excessive redemption premiums can result in imputed income to the holder of the preferred stock even if the premium is never paid by the company. To avoid this problem, it is prudent to follow the IRS safe harbor provisions by limiting any redemption premium to 1/4 percent per year.

Conversion Rights. Preferred stock issued in venture financings is almost always convertible into common stock at the holder's option. There is also a provision for automatic conversion upon the initial public offering of the company's stock or upon the vote of a majority of the preferred stock. To encourage investors to support the company when it is forced to raise money at a lower price than its previous round, you could have a provision that automatically converts preferred stock to common if the holder declines to purchase his or her pro rata share of a lower priced offering. This is referred to as a "pay to play" provision. Another form of "pay to play" provision will have such holder's shares automatically convert to a "shadow" preferred — identical to the original series of pre-ferred, but without antidilution protection. Typically, the preferred stock will be initially convertible on a one-to-one ratio. The conversion ratio is actually calculated by taking the original purchase price and dividing it by the conversion price. The initial conversion price is normally the original purchase price. The conversion ratio is adjusted for dilutive events or issuances, as discussed in Antidilution Protection below.

Antidilution Protection. Convertible preferred stock always contains provisions protecting it against dilution from stock splits and stock dividends, sometimes called "event protection." Frequently, there are also provisions protecting it against future sales of stock at lower prices, called "price protection." The most common price protection and that are most favorable to your company is a "weighted-average" adjustment of the conversion price. The weighted-average formula adjusts the conversion price by means of a weighted formula based upon both the sale price and number of shares sold. There are two types of weighted average antidilution: "broad based" and "narrow based." Broad-based protection includes preferred and options as well and stock dividends, sometimes called "event protection." Frequently, there are also provisions protecting it against future sales of stock at lower prices, called "price protection." The most common price protection and that are most favorable to your company is a "weighted-average" adjustment of the conversion price. The weighted-average formula adjusts the conversion price by means of a weighted formula based upon both the sale price and number of shares sold. There are two types of weighted average antidilution: "broad based" and "narrow based."

Broad-based protection includes preferred and options as well as common stock in the calculation and will result in a smaller adjustment if there is a "down" round of financing. Narrow-based protection may exclude options or the preferred and is less favorable to the company. If the investors think they are paying too much for the preferred, they may insist on "ratchet" antidilution protection, which drops the conversion price to the most recent

lower price at which stock was sold, regardless of how many shares were sold at that price. This protects investors who decline to participate in lower-priced offerings. The second scenario in Appendix A illustrates the effect of antidilution protection as converted to common-percentage stock ownership. In both cases, you should ensure that employee stock issuances and stock issued in mergers and lease financings are excluded from the definition of "dilutive issuances." Some venture capitalists won't include price-based antidilution protection so as to put more pressure on investors to support the company in bad times.

Voting Rights. Preferred stock typically votes with the common stock, on an "as if converted" into common stock basis. In addition, the preferred stock may be given the right to elect a certain number of directors to the company's Board of Directors, with the common stock electing the remainder. Applicable corporate law also gives the preferred stock class voting rights on certain major corporate events, such as mergers or the creation of senior preferred stock. Investors may wish to expand the items requiring a separate class vote. It is generally preferable to avoid series-voting rights since that gives a given series a veto right over items that might otherwise be approved by the shareholders as a whole and by each class of shareholders.

Registration Rights

In addition to the preferences discussed above, venture capitalists require an avenue to liquidity. This is usually achieved by a registration-rights agreement giving the investors the right to require your company to go public and register their shares with the SEC. These registration rights are called "demand rights." The investors may also have the right to require your company to register their shares with the SEC when the company decides to go public. These rights are referred to as "piggyback rights." In both cases, the company usually pays related expenses.

Typical Restrictions Imposed on Management

Venture capitalists generally require certain commitments from your company about its post-financing management. The covenants that you are likely to encounter are affirmative and negative covenants, rights of first refusal and co-sale rights.

Affirmative covenants generally require your company to provide the investors with ongoing financial information and access to the company's records and management and may grant the investors the right to board representation or board visitation rights.

Conversely, investors may also require negative covenants or company agreements not to take specified actions without the investors' consent. Your management must carefully evaluate these covenants to ensure that they will not unduly interfere with your board's ability to manage the company.

Investors also may obtain a "right of first refusal" on further stock issuances by your company. Typically, these provisions will give the investors the right to buy their proportionate share of any new stock offerings prior to the public offering. You should avoid a right of first refusal giving investors the right to buy all of a new issuance because that could make it hard for the company to attract new investors. In addition, certain types of offerings (such as stock issued in mergers, lease financings and to employees) should be excluded from the investors' right of first refusal.

In addition to these restrictions, the venture capitalists may require that the founders personally sign a co-sale agreement. A co-sale agreement gives the venture capitalists the right to participate in any proposed sale of the founder's stock to third parties. The reason for a co-sale agreement is that the investors generally do not want the founders to "cash out" without giving the investors the same opportunity. Both the right of first refusal and co-sale agreement should terminate upon a public offering or the company's acquisition.

Employee Stock Plans

Companies typically establish employee stock option plans to provide equity incentives for employees. Start-up companies are high risk and cash-flow constraints often mean that employees may be asked to accept below-market salaries to conserve cash in the start-up phase. Consequently, equity plans are essential to attract and retain top quality people in a start-up. The number of shares reserved for employee plans is typically 10 to 20 percent of the outstanding shares. It is typical for early stage companies (though not approved by the IRS) to establish a fair market value for common stock for such employee plans within a range of 10 to 20 percent of the most recent value of the preferred stock. This price differential must disappear as you approach a public offering or acquisition of the company or the company may be required to take a "cheap stock" charge to earnings by the SEC.

Corporate Partnering

As your company completes product development and moves into manufacturing and distribution, you should consider structuring some kind of partnering arrangement with one or more major corporations in your field. A strategic alliance with a major corporation can sharply accelerate your growth by providing you with an established manufacturing or distribution infrastructure, credibility, influence and immediate access to both domestic and international customers. (See the Fenwick booklet on Corporate Partnering for High Technology Companies for a detailed discussion on finding and negotiating partnering arrangements.)

When Should you Consider an Acquisition?

Many good companies discover after a number of years of effort that it is going to be difficult (if not impossible) to attain the level of revenues and profits set forth in their initial business plan. The product development cycle may be longer than anticipated, the market too small, the barriers to entry too great, distribution channels may be clogged, the company may not be able to develop follow-on products or the management team may not be up to the challenge of growing the company beyond a certain size. While any of these difficulties may restrict the company's future growth, the company's product or management team could still be highly valuable in the hands of a strategic buyer. For such companies, an acquisition may give investors a quicker and more certain path to liquidity. Alternatively, many technology companies have used acquisitions of related products or companies as a means to accelerate their own growth to the critical mass necessary for success. Since change seems to be the only constant in the life of a high tech company, you need to keep an open mind about the advisability of being acquired or acquiring other companies. (See the Fenwick booklet on Mergers and Acquisitions for High Technology Companies for a detailed discussion on issues and negotiating strategies in technology company acquisitions.)

Financing—the Second Round

At the next appropriate financing "window," or as your company begins to run out of cash, you may seek a second round of venture capital to start the next milestone of your business plan or to adapt to changed market conditions. How much control you are able to exercise during subsequent rounds of financing depends largely on how successful you have been in managing the planned development and growth of the company with previous funding and the degree to which investment capital is available.

Successful Companies

If your company has proven its ability to "execute" its business plan, you should be able to raise money at a substantial premium over the first-round, perhaps one and one-half to two and one-half or more times the first round price. The first-round venture investors will participate in the second round financing, typically providing one quarter to one half of the money in the second round. A lead investor representing the "new money" generally will set the second-round price and its terms and conditions. If the company runs out of cash before the lead investor is found, the current investors may "bridge" the gap by giving the company a bridge loan that will automatically convert into the next round series of preferred stock. Investors typically receive market rate interest and warrants for making bridge loans.

Unsuccessful Companies

If your company has fallen measurably short of its plan, finding new investors will be a problem and your existing investors may need to fund a greater percentage of the round.

Since the company will be in a weaker bargaining position, it may have to raise money at a lower price than the first round, triggering antidilution protection and causing significant dilution to the founders. More onerous preferred stock terms are likely, including pay-to-play provisions, ratchet-antidilution protection and multiple-liquidation preferences. In addition, the venture capitalists may force you to change management, replace the CEO, impose more rigorous controls over the company's management or force personnel layoffs.

When the existing investors lead a "down" round financing, it raises conflict of interest and fiduciary duty issues since the investors who are pricing the deal offered to the company are the same people who are approving the deal on the company's board of directors. Down-round financings should be structured to minimize the risk of liability to the board and its investors and maximize the fairness to the company's shareholders. For example, the company should conduct a "rights offering," permitting all company shareholders who are qualified investors for securities law purposes to participate in the offering and it could obtain an independent appraisal of the pre-money valuation of the company. Because down-round financings raise so many legal issues, consult your corporate counsel on how to best address these issues.

The Initial Public Offering

What are the Prerequisites for Going Public?

In order to go public, your company should establish a consistent pattern of growth and profitability and a strong management team. Your company's ability to go public will depend on market factors, as well as the company's revenue and profitability rate, its projections for future revenue and profit and the receptivity of the securities market. When market interest in technology is high, companies can be valued at levels that seem unrelated to their balance sheets or income statements. There is enormous pressure on companies to go public during these market windows. However, the IPO market is volatile and reacts to factors that are outside your company's control. Even if your company has met the profile described above, you may find that the IPO market window is effectively closed. If that happens, your only options may be self-funding, seeking additional venture funding or a sale to an established company.

Advantages of Going Public

There are two principal advantages to going public. First, the company can raise a larger amount of capital at a higher valuation than it could obtain from private investors because "public" shares can be freely resold. Second, going public can boost your company's sales and marketing by increasing its visibility. From the individual's point of view, some venture capitalists and key managers may sell a small portion of their stock in the initial public offering (IPO) or a follow-on offering, giving them liquidity.

Beyond these advantages, the founders achieve a psychological sense of financial success. Before the IPO, they owned shares with no market and no readily ascertainable price. After the offering, the public market sets the price and provides them liquidity.

Disadvantages of Going Public

There are a number of disadvantages to going public. A public offering is expensive. For example, if your company wanted to make a $40 million offering, the underwriters typically would take a seven percent commission on the stock sold, and the legal, accounting and printing fees would exceed $1.2 million. Once public, your company must publish quarterly financial statements and disclose information you previously considered confidential. The SEC is increasing the scope of information public companies must make available to the public and holding the CEO and CFO responsible for the accuracy of the information provided to the public. In making business decisions, your company's Board of Directors will have to consider the effect on the company's stock price. Failing to meet analysts' expectations can lead to a dramatic drop in the company's stock price. In a very real sense, entrepreneurs tend to feel that they lose control of "their" company after the IPO.

Conclusion

For many high technology start-ups, a venture capital financing strategy is the only realistic way that their new product ideas can be successfully developed and introduced into the marketplace. Without the capital infusions and the management assistance of venture capitalists, many of these companies' products simply would not make it to the public market. Entrepreneurs have an abundance of good ideas and the drive to realize them. The management and market experience they may lack can be provided by the relationships they develop with experienced venture capitalists, accountants and lawyers who focus in working with high technology companies.

Appendix A: Illustrative Financing Scenarios

In order to give you a better idea of what you can expect in the way of share ownership or company valuation if you decide to pursue a venture capital financing strategy, we have prepared two illustrative financing scenarios. Both assume that the company was able to raise the necessary funding to develop and bring its product to market and that the company's product was ultimately accepted by the marketplace. The first scenario assumes a strong, experienced founding team, with strong and continuous growth in product development, marketing and sales, while the second assumes a less experienced team that stumbles, but does not fail, in its objectives, but faces the effects of a down-round financing.

It is difficult to generalize about the percentage ownership founders may retain by their company's IPO. While these scenarios provide some realistic parameters, actual valuations will depend on the attractiveness of the given investment and market conditions at the time.

Highly Successful Team

If you gathered a very strong management team, developed a product with strong market acceptance and were both lucky and particularly successful at executing your business plan, your company's valuation round-by-round and the distribution of your company's outstanding shares at the IPO might be similar to that set forth below:

Shareholders	No. Shares	Purchace Price	Dollars Invested	Company Valuation	% Ownership at IPO
Founders (Common)	4,250,000	$ 0.001	$ 4,250	$ 4,250	22 %
Seed Investors (Preferred)	1,000,000	0.50	500,000	2,625,000	5
Round 1 Inv. (Preferred)	3,500,000	2.00	7,000,000	17,500,000	18
Employees (Common)	1,750,000	0.20	350,000	21,000,000	9
Round 2 Inv. (Preferred)	5,000,000	4.50	22,500,000	69,750,000	26
Employees (Common)	2,000,000	0.45	900,000	78,750,000	10
Public (Common)	2,000,000	20.00	40,000,000	390,000,000	10
Total	19,500,000				100 %

Appendix B: Series B Preferred Stock Term Sheet

Amount of Financing:	$7,000,000		
Type of Security:	3,500,000 shares of Series B Preferred Stock ("Series B Preferred")		
Purchase Price:	$2.00 per share (a $14 million pre-money company valuation)		
Projected Postfinancing Capitalization:		Number of Shares	%
	Common Stock	4,250,000	40%
	Series A Preferred	1,000,000	10%
	Series B Preferred	3,500,000	33%
	Employee Options	1,750,000	17%
	Total:	10,500,000	100%

Rights and Preferences of Series B Preferred

Dividend Rights The holders of the Series A and Series B Preferred Stock (collectively the "Preferred Stock") shall be entitled to receive, out of any funds legally available therefore, dividends at a rate of eight percent per year (i.e., $.04 and $.16 per share for the Series A and B Preferred, respectively) prior and in preference to any payment of any dividend on the Common Stock. Such dividends shall be paid when, as and if declared by the Board of Directors and shall not be cumulative.

Liquidation Preference In the event of any liquidation, dissolution or winding up of the Company, the holders of the Preferred Stock will be entitled to receive an amount equal to their original issue price per share, plus an amount equal to all declared but unpaid dividends thereon (the "Preference Amount"). If there are insufficient assets to permit the payment in full of the Preference Amount to the preferred shareholders, then the assets of the Company will be distributed ratably to the holders of the Preferred Stock in proportion to the Preference Amount each holder is otherwise entitled to receive.

After the full Preference Amount has been paid on all outstanding shares of Preferred Stock, any remaining funds and assets of the Company legally available for distribution to shareholders will be distributed ratably among the holders of the Preferred and Common Stock on an as-converted basis.

A merger or consolidation of the Company in which its shareholders do not retain a majority of the voting power in the surviving corporation, or sale of all or substantially all the Company's assets, will be deemed to be a liquidation, dissolution or winding up.

Conversion Right The holders of the Preferred Stock shall have the right to convert the Preferred Stock at any time into shares of Common Stock. The initial conversion rate for each series of Preferred Stock shall be 1-for-1.

Automatic Conversion The Preferred Stock shall be automatically converted into Common Stock, at the then applicable conversion rate, upon the closing of an underwritten public offering of shares of Common Stock of the Company at a public offering price of not less than $6.00 per share and for a total public offering amount of not less than $10 million.

Antidilution Provisions Stock splits, stock dividends and so forth shall have proportional antidilution protection. The conversion price of the Preferred Stock shall be subject to adjustment to prevent dilution on a weighted average basis in the event that the Company issues additional shares of Common Stock or Common Stock Equivalents at a purchase price less than the applicable conversion price; except that shares of Common Stock sold or reserved for issuance to employees, directors, consultants or advisors of the Company pursuant to stock purchase, stock option or other agreements approved by the Board and certain other issues customarily excluded from triggering antidilution adjustments may be issued without triggering antidilution adjustments.

Voting Rights Each share of Preferred Stock carries a number of votes equal to the number of shares of Common Stock then issuable upon its conversion into Common Stock. The Preferred Stock will generally vote together with the Common Stock and not as a separate class except that, with respect to the election of the Board of Directors, the holders of Preferred Stock may elect three of the five members of the Board. The holders of the Common Stock, voting together as a single class, shall be entitled to elect the two remaining Board members.

Board Representation At the Closing Date, the Board of Directors shall consist of Joe CEO, Industry Luminary, Bill VC, Tom VC and Michele VC.

Protective Provisions Consent of the holders of a majority of the outstanding Preferred Stock shall be required for: (i) any action that materially and adversely alters or changes the rights, preferences or privileges of any series of Preferred Stock; (ii) any action that authorizes or creates shares of any class of stock having preferences superior to or on a parity with any series of Preferred Stock; (iii) any amendment of the Company's Articles of Incorporation that materially and adversely affects the rights of any series of the Preferred Stock; (iv) any merger or consolidation of the Company with or into one or more other corporations in which the Company's shareholders do not retain a majority of the voting power in the surviving corporation or (v) the sale of all or substantially all the Company's assets.

Rights of First Refusal So long as an investor holds at least five percent of the Company's outstanding capital, that holder of Preferred Stock shall be given the right of first refusal to purchase up to its pro-rata portion (based on its percentage of the Company's outstanding common shares, calculated on an as-if-converted basis) of any equity securities offered by the Company (other than shares offered to employees, in a merger or in connection

with a lease line or line of credit, etc.) on the same terms and conditions as the Company offers such securities to other potential investors. This right of first refusal will terminate immediately prior to the Company's initial underwritten public offering of its Common Stock at a public offering price of not less than $6.00 per share and for a total public offering amount of not less than $10 million.

Information Rights So long as an investor continues to hold at least 5 percent of the Company's outstanding Common Stock (calculated on an as-converted basis), the Company shall deliver to the investor: (i) audited annual financial statements within 90 days after the end of each fiscal year; (ii) unaudited quarterly financial statements within 45 days of the end of each fiscal quarter and (iii) unaudited monthly financial statements within 30 days of the end of each month. These information rights shall terminate upon the Company's initial public offering.

Registration Rights

(1) *Demand Rights* If at any time after the third anniversary of the closing holders of at least 30 percent of the "Registrable Securities" (defined below) request that the Company file a registration statement covering the public sale of Registrable Securities with an aggregate public offering price of at least $5 million, then the Company will use its best efforts to cause such shares to be registered under the Securities Act of 1933 (the "1933 Act"); provided, that the Company shall have the right to delay such registration under certain circumstances for up to 90 days during any 12-month period. "Registrable Securities" will mean the Common Stock issuable on conversion of the Preferred Stock.

The Company shall not be obligated to effect more than two registrations under this demand right provision and shall not be obligated to effect a registration during the six-month period commencing with the date of the Company's initial public offering or any registration under the 1933 Act in which Registrable Securities were registered.

(2) *Piggyback Rights* The holders of Registrable Securities shall be entitled to "piggyback" registration rights on all 1933 Act registrations of the Company or on any demand registration (except for registrations relating to employee benefit plans and corporate reorganizations).

(3) *Cutback* The investors' registration rights are subject to the right of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions. The underwriters' "cutback" right shall provide that at least 25 percent of the shares included in the Registration must be Registrable Securities (except for the Company's initial public offering, from which all Registrable Securities may be excluded).

(4) *S-3 Rights* Investors shall be entitled to registrations on Form S-3 (if available to the Company) unless: (i) the aggregate public offering price of all securities of the Company to be sold by shareholders in such registered offering is less than $500,000; (ii) the Company certifies that it is not in the Company's best interests to file a Form S-3, in which event the Company may defer the filing for up to 90 days once during any 12-month period or (iii) if the Company has already effected two registrations on Form S-3 during the preceding 12 months.

(5) *Expenses* The Company shall bear the registration expenses (exclusive of underwriting discounts and commissions, but including the fees of one counsel for the selling shareholders) of all such demand and piggyback registrations and for the first S-3 registration.

(6) *Transfer of Rights* Registration rights may be transferred to (i) transferees acquiring at least 100,000 shares of Registrable Securities with notice to and consent of the Company or (ii) any partner, shareholder, parent, child or spouse of the holder or to the holder's estate.

(7) *Market Standoff* No holder will sell shares within such period requested by the Company's underwriters (not to exceed 180 days) after the effective date of the Company's initial public offering; provided, however, that such restriction does not apply to Registrable Securities included in such registration statement; and provided further, that all officers, directors and holders of more than 1 percent of the outstanding capital stock of the Company enter into similar standoff agreements with respect to such registration.

(8) *Cross-Indemnification Provisions* The parties will provide each other with reasonable cross-indemnification.

(9) *Termination* The registration rights will terminate five years after the closing of the Company's initial public offering and will not apply to any shares that can be sold in a three-month period pursuant to Rule 144 without registration.

Board of Directors The Articles of Incorporation and Bylaws shall provide for a five-person Board of Directors.

Stock Purchase Agreement The investment shall be made pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein, and appropriate conditions of closing, including an opinion of counsel for the Company. The Stock Purchase Agreement shall provide that it may be amended by or that provisions may be waived only

with the approval of the holders of a majority of the Series B Preferred (and/or Common Stock issued upon conversion thereof). Registration rights provisions may be amended with the consent of the holders of a majority of the Registrable Securities.

Stock Vesting Stock sold and options granted to employees will be subject to the following vesting, unless otherwise approved by the Board of Directors: (i) Vesting over four years — 24 percent of the shares vest at the end of the first year, with two percent of the shares vesting monthly thereafter; or (ii) Upon termination of the shareholder's employment, with or without cause, the Company shall retain the option to repurchase at cost any unvested shares held by such shareholder.

Restrictions on Sales The investors will make the customary investment representations.

Invention Assignment Agreement: Each officer and employee of the Company shall have entered into an acceptable confidentiality and invention assignment agreement.

Finders The Company and the investors shall each indemnify the other for any finder's fees for which either is responsible.

Legal Fees and Expenses The Company shall pay the reasonable fees and expenses of Investors' counsel up to a maximum of $30,000.

About the Author

Jacqueline A. Daunt retired from Fenwick & West LLP in 2003 after more than 21 years in the firm's Corporate Group. Her practice focused on representing high technology clients in domestic and international transactions, including venture financings, mergers and acquisitions, partnering arrangements, distribution and licensing agreements and international protection of proprietary rights. Ms. Daunt received her B.A. in economics and her J.D. from the University of Michigan. She also attended the Université Libre de Bruxelles and L'Institut D'Études Européennes, where she studied comparative commercial law and European antitrust law. In addition to frequent speaking engagements, Ms. Daunt has authored during her career a series of booklets on strategic issues for high technology companies, including Venture Capital, Corporate Partnering, Mergers and Acquisitions, Structuring Effective Earnouts, International Distribution and Entering the U.S. Market. Ms. Daunt's booklets have been distributed to tens of thousands of entrepreneurs, students, venture capitalists and journalists and are widely regarded as the most useful and straightforward reference materials of their type. Fenwick is deeply indebted to Ms. Daunt for her tireless efforts in writing and maintaining these invaluable resources.