

Venture Capital Financing: Structure, Valuation and Securities Law Considerations

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- I. Introduction
 - A. Overview of some of the basic legal, financial and securities law aspects of venture capital investments.
 - B. Topics to be covered:
 - 1. Structure of Venture Capital Investments.
 - 2. Valuation Considerations.
 - 3. Terms of the Deal.
 - 4. Choice of Entity.
 - 5. Securities Laws Issues.
 - 6. Alternative Sources of Investment.
- II. Structure of Venture Capital Investments.
 - A. Range of Possible Alternatives:
 - 1. Straight debt.
 - 2. Debt with equity features (i.e., debt convertible into stock or accompanied by warrants).
 - 3. Convertible preferred stock (having some features of debt but convertible into common stock).
 - 4. Common Stock.
 - B. Debt.
 - 1. Features attractive to investors:
 - a) Preferred position in case of liquidation.

- b) Current income.
 - c) Remedies in case of default.
2. Disadvantages.
- a) Does not provide upside advantage for investor.
 - b) Since accrued interest is an expense, debt makes the company's balance sheet less attractive; also may impede access to credit and future financings.
 - c) Usually unavailable for information technology companies with few assets to collateralize debt.
 - d) Company may not be able to pay, especially if in development stage.
- C. Debt with Equity Features.
1. Convertible debentures.
- a) Principal and accrued interest may be converted at option of holder into common stock of the company at a specified conversion rate.
 - b) Allows investor to assess whether the company's performance and earnings are sufficient to motivate conversion to equity position.
 - c) Preferred position ahead of equity holders upon liquidation.
 - d) Often tie conversion rate to next "real" financing which raises at least a minimum amount. Defers valuation decision.
2. Debt with Warrants or Common Stock Attached.
- a) Generally sold together as a "unit" in the private placement, with most of allocation to debt.
 - b) Debt repaid even if warrants exercised; disadvantageous to the company.
 - c) If company is "S" corporation, care must be taken not to violate the IRS's prohibition on two classes of stock.

D. Convertible Preferred Stock.

1. Investors pay for preferred at a substantial premium over founders and seed stage investors.
2. Convertible into common stock at an agreed upon rate.
3. Has preferences over common holders for dividends, liquidation and redemption.
4. Often combined with other control features.
5. Improves debt-to-equity ratio.
6. Most typical form of venture capital investment.

E. Common Stock.

1. Very risky format for investor to take straight common stock alone.
2. No preferred position, dividend or control over management.
3. Least flexible for exit.
4. Sometimes used in friends & family or angel financing.

III. Valuation Considerations.

A. Introduction: Once the decision is made to finance the company through the sale of equity interests, the most important decision the company makes is fixing a value to price the investment. For any company without a public market which objectively fixes values, this is complex, but for software, internet and other technology companies, this is even more difficult. In most industries, companies with weak balance sheets, no profits, a product just introduced into the market or even negative net worth would be ignored by investors. Until recently, information technology companies with these characteristics have been financed at wildly high valuations in both the private and public capital markets. The following list sets forth some of the basic valuation methods which are based on objective criteria. Despite the objective valuation analysis, many valuations are based on a subjective determination of the technology's potential value and/or hype.

B. Multiple of Sales

1. Most common method.

2. Sales revenues multiplied by a chosen factor.
3. Often tied to trailing 12 months of sales.
4. Commonly used range for private software companies is multiple of 1.5 to 2.2.
5. Consider all revenue sources:
 - a) Products sales;
 - b) Maintenance fees; training and support; royalties; and
 - c) Ancillary consulting fees.
6. Difficult to use for start-ups or young companies with limited track record.

C. Price-Earnings Ratio.

1. Multiply earnings by a factor.
2. Also typically use trailing 12 months.
3. Multiple range is often between 10 and 20 for software companies.
4. Use substantial discount from comparable public companies.
5. Also hard to use for very young companies.
6. Problem that earnings for private companies often don't reflect true profitability.
7. Comparable company analysis: what was multiple for private company acquired by public company?

D. Replacement Value.

1. Cost to replicate new product from scratch.
2. Often expressed in person years multiplied by cost per year.
3. Useful for companies without significant earnings or sales.
4. Research and development is major factor.

E. Discounted Cash Flow.

1. Projected future income is discounted to present value

2. Usually includes a range based on worst and best case profit scenarios.

3. Caveat: projections notoriously unreliable.

F. General.

1. These methods not exclusive, may want to use several methods and calculate a weighted average.

2. Calculations may supplement an evaluation of the market potential of the company or comparison with similar deals recently financed.

G. Dilution.

1. Distinction between “price dilution” and “percentage dilution.”

2. When is a percent not a percent?

3. Pre money vs. post money.

4. What “fully diluted” means (convertible into, exercisable or exchangeable for)

5. Save this formula:

$$X = (OS \div (1-PC)) - OS$$

where:

X = the number of shares to be issued to the VC

OS = the number of shares outstanding prior to the sale to the VC, including options, warrants, etc.

PC = the percentage of the company the VC wants to own after making the investment, calculated on a fully diluted basis.

IV. Terms of the Deal.

A. Introduction: Classical venture capital deal is structured as convertible preferred stock whereby investors receive certain preferences and controls with the opportunity to maximize the upside of their investment.

B. Typical Preferred Stock Features.

1. Dividend Preference.

a) Holders receive dividends before common.

b) Mandatory vs. “as, if and when declared.”

- (i) Mandatory: comparable to interest on debt; rarely used.
 - c) Cumulative vs. non-cumulative.
 - d) Range and timing.
 - (i) Can range from 0% to high coupon rates.
 - (ii) Timing of dividends is flexible, i.e. no dividends for two years, then payable quarterly.
 - (iii) Can make accrual or payment contingent on profitability to assist in development stage.
 - e) Accrue only for purposes of conversion.
2. Liquidation Preference.
- a) Holders receive a return of their capital plus accrued dividends before common holders receive anything upon liquidation.
 - b) Key issue: does sale of assets, merger, etc. constitute “liquidation”?
 - (i) Investors usually insist on this so that they can choose to receive their preference payment upon a merger or other sale of the company.
 - c) Participating preferred.
 - d) Multiples, caps and other variations.
3. Redemption.
- a) Means to facilitate or guarantee exit for investors.
 - b) Company’s repurchase of stock is either optional or mandatory.
 - c) Optional redemption lets the company repurchase the preferred stock, usually after a specified period following the initial investment, for the original purchase price plus accrued but unpaid dividends (in effect a “call” right). A redemption premium based on a percentage of the purchase price is often added.

- d) Mandatory redemption (a “put”) lets the investors force the company to redeem the stock after a specified period, also at purchase price plus dividends, plus, in some cases, a premium.
 - e) Premium often increases in later years to provide a “cost” to the company for not providing a more profitable exit expected by the investors.
 - f) More as cosmetic than real exit.
4. Conversion rights.
- a) Lets the investor decide, based on company performance, on the assured return of the preferred stock (the liquidation, dividend and redemption preferences) vs. holding common stock.
 - b) Typical provision provides for automatic conversion upon an initial public offering to avoid having class of stock with superior rights outstanding. Often a minimum dollar amount which must be raised in the offering will be specified so that a very small IPO (and the likely consequence of a limited trading market in the company’s stock) will not trigger conversion.
 - c) Conversion rate is usually fixed at a simple one-for-one basis.
5. Anti-dilution provisions.
- a) All preferred stock contains protection against the dilution of the holders’ interest in the company in case of stock splits, stock dividends, mergers and other corporate combinations.
 - b) Usually will have “price protection” whereby the conversion rate will be adjusted to give the investor the right to receive additional common stock if the company sells stock in the future at a lower price than sold to the investors.
 - c) “Weighted average” adjustment used to be the most typical method. This method uses a weighted formula which takes into account the number of shares outstanding, the number of shares sold and the price of the alter offering.

- d) “Ratchet” anti-dilution simply reduces the conversion price of the preferred stock to the price of recent stock sales. This method imposes a strong penalty which may impede future financings by forcing the pricing of the later deal to be made at a lower rate.
- e) Generally exempt shares issued under employee option plans, acquisitions, strategic alliances, warrants to banks, lessors.

6. Voting

- a) Preferred stock usually votes as if converted to common.
- b) Often has the right to designate one or more directors.
- c) Common control provisions will require consent of the investors to merge or sell a substantial portion of the company’s assets or to take any action which reduces the rights of the holders of preferred stock. May have very detailed control rights (budget, hiring of C level executives) in early stage companies by either the designated director or by vote of the preferred holders.

7. Registration Rights.

- a) Investors usually negotiate a provision that in the event the company goes public, the investors’ common stock will be registered for public sale under the Securities Act of 1933.
- b) Demand registration rights allow the investors to require the company to register their stock upon request, usually commencing upon a specified period after the IPO (six months is market norm) and for a period of five to seven years thereafter.
- c) “Piggyback” registration rights allow investors to sell their stock when the company is otherwise selling shares in a public offering. This is usually subject to the consent of the underwriter and the ability to cut back the amount being sold by investors if the underwriter thinks it will impede the offering.
- d) S-3 registrations.
- e) Terminates when holder can sell freely under Rule 144.

8. Tag Along and First Refusal Rights.

- a) Also known as “co-sale” rights, gives the investors the ability to participate on a pro rata basis and on the same terms of a private sale by the principals of the company of all or a portion of their stock. Exclusion for estate planning transfers.
- b) Prevents founders from cashing out ahead of investors.
- c) “Drag along” rights.
- d) Investors often negotiate a right of first refusal, whereby investors receive the right to buy a proportionate share of new stock issuances for a specified period, reducing dilution of their investment in the subsequent offering.
- e) “Pay or Play” provisions.

C. Phased Investments Based Upon Performance.

- 1. Investors in early stage companies increasingly want to make investments in stages.
- 2. Benchmarks based on reaching defined milestones.
 - a) Development of working prototype.
 - b) Beta testing.
 - c) Product roll-out.
 - d) Specified sales/net income levels.

D. Documents

- 1. Term Sheet/Letter of Intent
- 2. Stock Purchase Agreement
 - a) Representations and Warranties
 - (i) by Company
 - (ii) by Investors
 - (iii) percent investment
- 3. Certificate of Designation or Amended and Restated Certificate of Incorporation

4. Investors' Rights Agreement
5. Re-Sale Agreement
6. Opinion of Company Counsel

V. Impact of Choice of Entity

A. Conventional choice is to incorporate early in the development stage.

1. Take advantage of the corporate form to limit liability.
2. Easy transferability of interests.
3. Uniformly recognized elements of structure and administration.
4. Control in hands of management.
5. Easy to restructure on a tax-free basis.
6. Disadvantage: double layer of taxation on the income of the corporation and on distribution of earnings to stockholders.

B. Small businesses often elect S corporation status to eliminate tax on corporate earnings.

1. Regular corporation for state corporate law purposes.
2. Single level of tax; income and losses pass through the corporation and are taxed to or deducted by the shareholders.
3. Restrictions imposed by Internal Revenue Code include the following:
 - a) No more than 35 shareholders.
 - b) Only individuals, estates or certain trusts may be shareholders. No corporate shareholders.
 - c) May not have more than one class of stock, although certain differences in voting rights are permitted.
4. These restrictions mean that an S corporation will be unsuitable for most venture capital investments. The single class of stock restriction precludes the use of preferred stock. The limitation that generally only individuals may be shareholders rules out most of the entities which are sources of venture capital.

- C. Use of Limited Liability Companies.
 - 1. Unincorporated business organization pursuant to state law.
 - 2. Preserves the limitation on liability of the corporate form.
 - 3. No restrictions on the number of members, the nature of any member or how the investment is structured. Any type of preferential return to investors is permissible.
 - 4. Summary: combines the tax advantages of a pass-through entity with the flexibility and limited liability of a C corporation.

- D. Caution on Usage
 - 1. Us of LLC may be cumbersome is a number of investors are anticipated, or if a number of financing rounds are planned.
 - 2. Withdrawal of a member generally causes the dissolution of the LLC. Although the remaining members will generally be permitted to continue the business, this can cause practical problems arranging the vote, particularly if withdrawals occur regularly.
 - 3. The foregoing restrictions make an LLC unworkable for being a publicly traded entity. With proper tax planning, an LLC can generally be converted to a corporation in anticipation of an IPO without adverse consequences.

VI. Securities Laws Issues.

- A. All sales of stock both to the founders and to subsequent investors must comply with the rules and regulations established by the Securities Act of 1933 and the Blue Sky laws of each state of which any holder of an equity interest is a resident.
- B. Requirement to Register.
 - 1. Section 5 of the Securities Act of 1933 provides the general rule that it is unlawful, absent an available exemption, for any person to directly or indirectly use interstate commerce or the mails to offer to sell a security unless a registration statement has been filed with the Securities and Exchange Commission.
 - 2. Failure to comply has serious consequences, including rescission of the sale of any securities, damages, criminal prosecution and injunctive action by regulatory authorities.

C. Principal Relevant Exemptions from Registration Requirements:

1. Section 4(2) Non-public offerings
2. Section 4(6) Sale to Accredited Investors
3. Section 3(a)(11) Intrastate offering exemption
4. Regulation A Small offering registration
5. Regulation D Limited offering exemption for non-public sales

D. Regulation D

1. Before the advent of Regulation D in 1982, most private placements relied on the Section 4(2) exemption, “transactions by an issuer not involving a public offering.” The statute does not define what constitutes a non-public offering, so for many years it was left to the SEC and the courts to define the standard. In general, the exemption is available for offerings involving sophisticated offerees and purchasers who have access to the same kind of information made available to investors in a registered public offering and where no public solicitation is made. The larger the group of offerees, the less knowledgeable and sophisticated they are, the less of a pre-existing relationship there is between the issuer and the offerees, and the less information given to investors, the harder it will be to sustain the exemption under Section 4(2).
2. To alleviate the uncertainty of what offerings will or will not be considered a Section 4(2) private placement, the SEC adopted Regulation D in April 1982 (replacing Rule 146 promulgated in 1974) to create a “safe harbor” under setting forth criteria for the types of limited offerings which will be exempt from registration.
3. Regulation D not exclusive. Can still preserve a Section 4(2) or other exemption without meeting Regulation D criteria. Only one of the three types of Regulation D offerings, Rule 506, is a 4(2) exemption.
4. Impact of NYSMIA and general Blue Sky issues..

E. Three types of Offerings Under Regulation D.

1. Rule 504.

- a) No more than an aggregate of \$1,000,000 worth of securities may be sold in the offering, including any securities sold within the preceding 12 months.
 - b) Not available for public companies.
 - c) No limit on number of investors.
 - d) No limitations on manner of offering (rules regarding prohibition against general advertising and solicitation do not apply.)
 - e) Securities sold not treated as restricted.
 - f) No information required to be furnished to investors.
 - g) In effect, the SEC has deregulated Rule 504 offerings and left regulation of small issuances to state Blue Sky laws.
 - h) Items (d) and (e) above only apply if certain Blue Sky laws require delivery of a substantive disclosure document or provide for registration.
2. Rule 505.
- a) No more than an aggregate of \$5,000,000 worth of securities may be sold in the offering, including securities sold within preceding 12 months.
 - b) No more than 35 non-accredited investors.
3. Rule 506.
- a) No limit as to size of offering.
 - b) No more than 35 non-accredited investors (non-accredited investor must be able to evaluate merits and risks).
4. Other Requirements for Rule 505 and 506 Offerings.
- a) For both Rule 505 and 506, there are no disclosure requirements for sales to accredited investors. If sales are made to non-accredited investors, the issuer must meet the information requirements of Rule 502(b), which vary depending on size of offering.
 - b) No general solicitation or advertising.

- c) Restrictions on resale.
5. Caveat Regarding Disclosure.
- a) In any sale of securities, regardless of registration or the use of an exemption from registration, the anti-fraud rules of the U.S. securities laws will still apply.
 - b) Rule 10b-5: no untrue statements of a material fact or omissions to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.
 - c) Even where no information is required to be given in a Rule 504 offering or to accredited investors in a Regulation D offering, it is advisable to supply information which diminishes exposure under the anti-fraud provisions and Rule 10b-5.
 - d) Typical Sections of Private Placement Memorandum.
 - (i) Summary of the deal or term sheet.
 - (ii) Risk factors.
 - (iii) Description of the company, including business strategy.
 - (iv) Summary financial information.
 - (v) Use of proceeds.
 - (vi) Management, including executive compensation.
 - (vii) Ownership of securities.
 - (viii) Related party transactions.
 - (ix) Financial statements and projections.
 - e) Relevant parts of an Offering Memorandum sometimes incorporated the Business Plan.

VII. Alternatives to Venture Capital

A. Family, Friends and Associates

1. Companies generally exhaust the obvious sources of investment based on relatives and acquaintances in the earliest stages of development.
2. Useful to do a sustained and methodical review of all potential investors based on the connections of the principals of a company, particularly after a product has developed or as the company is beginning product roll-out.
3. Approach school alumni in a related field, relatives of friends, friends of relatives.

B. Angels.

1. Hardest source to tap because of difficulty in identifying sources.
2. Most likely to find in investment and business leaders in similar technology field.

C. Corporate Partners and Strategic Allies.

1. Technology companies frequently structure some form of partnering arrangement to assist product commercialization.
2. Principal areas:
 - a) Research and development
 - b) Manufacturing
 - c) Marketing and distribution
3. Sometimes can combine these transactions with an investment by the partner.
 - a) Similar terms to venture capital investment.
 - b) Company will seek better terms from a partnering company since partner will reap commercial benefits.
 - c) Partner may want additional restrictions to preclude competition.

d) Partner may seek exit rights if alliance fails or does not meet milestones.

D. Build an Investment Constituency Before You Need the Money.

1. Cultivate supporters interested in the company's vision and potential.
2. People and companies with a direct relationship to your company: customers, suppliers, developers.
3. Build constituency over time; industry experts, columnists.
4. Utilize professionals: lawyers, accountants, investment bankers.