

Welcome to
RISE WEEK 2011

Funding Your Start-Up

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Overview



- Current Financing Market
- Seed Financing
- Venture Financing
- Bootstrapping
- Government Funding
- Questions & Answers
- Appendix A – Key Terms
- Appendix B – An Entrepreneur’s Guide to Venture Capital Financing Terms
- Appendix C – Example Term Sheet for Series A Preferred Stock Financing

Current Financing Market

Current Financing Market



- Institutional capital was up in 2010 relative to 2009, but still below pre-crash levels
- Valuations have stabilized and in hot sectors are rising; hot start-up valuations are exploding
- IPO market rebounded in 2010 and expected to be strong this year as well
- M&A has also rebounded in 2010 and expected to be strong this year as well
- Liquidity events are still typically 6-8 years out; M&A is still the most common exit
 - This is making early stage capital harder to get
- Hard to get new money to pull the trigger
 - Typically takes 6 to 12 months
 - Expect to talk to dozens of VCs
- Harder to get early stage capital in Austin

Current Financing Market



- Extensive due diligence on the business plan, market, founders and management
- Focus is on solid, sustainable, capital efficient business models with **experienced management**
 - *Businesses* are fundable, *ideas* are not
- Valuation Drivers: Developed product; paying customers; revenue; large addressable market; strong management team; proprietary technology/barriers to entry
- Choose competent and experienced advisors
 - Focused expertise provides efficiencies
 - Know trends in deal terms
 - Can make introductions to sources of capital and other experienced service providers
- Avoid creating due diligence/deal issues



Seed Financing

- Debt v. Equity
 - Debt generally allows the company to defer valuation discussions (subject to caps, etc.)
 - Debt is generally easier to document and faster to close
 - Equity requires a valuation discussion
 - Small equity round more complicated and expensive to close, but can use seed stage equity type documents to be more efficient
- **Straight Loan** – very simple and no valuation needed, but no upside to investor; rarely used

- Bridge Loan
 - Type 1: Convertible at next round price with X% warrant coverage.
 - Close at least \$250,000 to avoid Texas state usury laws
 - Type 2: Convertible at discount to next round price **but** could create “usury” issues under Texas law
 - Equity “kicker” provides more incentive/return to investors

- Seed Equity Round
 - Must set a valuation for the round
 - Takes a little longer to get closed
 - Can use seed stage structure that is very basic to be more efficient
 - Examples: TechStars Seed docs; Series Seed docs; Founders Institute; yCombinator Docs
 - Eliminate or substantially reduce the rights of investors relative to a full-blown Series A Preferred Stock round

- Miscellaneous
 - Friends and family (be wary of violating securities laws)
 - Angel Investors
 - Typically individuals; active/former entrepreneurs
 - Typically Invest \$100,000-\$1,000,000
 - May provide guidance and advice to founders/CEO
 - Often want to help entrepreneurs and “give back”
 - Start-Up Incubators/Accelerators
 - Capital Factory
 - Y Combinator
 - TechStars



Venture Financing

Venture Capital Model



Capitalization Summary

	Series A Financing	Series B Financing	Series C Financing	IPO
Fully-Diluted Outstanding Value (pre-money)	\$5,000,000	\$20,000,000	\$50,000,000	\$150,000,000
New Money	\$5,000,000	\$10,000,000	\$25,000,000	\$75,000,000
Target Post-Money Option Pool	18.0000%	18.0000%	18.0000%	18.0000%
Price Per Share	\$0.6400	\$1.1395	\$1.6907	\$3.0103
Fully-Diluted Outstanding Value (post-money)	\$10,000,000	\$30,000,000	\$75,000,000	\$225,000,000

Capitalization	Organization		Series A Financing		Series B Financing		Series C Financing		IPO	
	Shares	Percent	Shares	Percent	Shares	Percent	Shares	Percent	Shares	Percent
Founder 1	2,500,000	40.00%	2,500,000	16.00%	2,500,000	9.50%	2,500,000	5.64%	2,500,000	3.34%
Founder 2	2,500,000	40.00%	2,500,000	16.00%	2,500,000	9.50%	2,500,000	5.64%	2,500,000	3.34%
Option Pool	1,250,000	20.00%	1,250,000	8.00%	2,812,499	10.68%	4,738,869	10.68%	7,984,666	10.68%
Option Pool Increase			1,562,499	10.00%	1,926,370	7.32%	3,245,797	7.32%	5,468,952	7.32%
Series A Preferred Stock Investor			7,812,499	50.00%	7,812,499	29.67%	7,812,499	17.61%	7,812,499	10.45%
Series B Preferred Stock Investor					8,775,684	33.33%	8,775,684	19.78%	8,775,684	11.74%
Series C Preferred Stock Investor							14,786,424	33.33%	14,786,424	19.78%
Public Investors									24,914,112	33.33%
Total (fully diluted)	6,250,000	100.00%	15,624,998	100.00%	26,327,052	100.00%	44,359,273	100.00%	74,742,337	100.00%

Financing	Money	Shares	Money	Shares	Money	Shares	Money	Shares
Price per share	\$0.6400		\$1.1395		\$1.6907		\$3.0103	
New Investment	\$5,000,000	7,812,499	\$10,000,000	8,775,684	\$25,000,000	14,786,424	\$75,000,000	24,914,112

Option Pool Detail	Shares	Percent	Shares	Percent	Shares	Percent	Shares	Percent
Total Current	1,250,000		2,812,499		4,738,869		7,984,666	
Pool Increase	1,562,499		1,926,370		3,245,797		5,468,952	
New Total	2,812,499	18.0000%	4,738,869	18.0000%	7,984,666	18.0000%	13,453,618	18.0000%

- Venture Capital
 - Typically expect a lot of control
 - Typically only target businesses that have at least a \$500 million market
 - Goal is to maximize financial return for limited partners
 - Ideally provide market expertise and can open doors and make introductions for a portfolio company
 - Add credibility
- Choose carefully, because a VC will be your “partner” for a long time
- Be wary of using “finders” because unless they are registered broker-dealers their involvement may violate securities laws
- Use caution with strategic investors early on
 - Often have different motivations from financial investors
 - May limit flexibility

- VC terms are fairly customary, subject to geographic nuances
 - East Coast v. West Coast
- Expectation of speed, efficiency and simplicity
- Principals focus on core issues at term sheet stage and expect that not much time will be spent on the definitive agreements
- **The Series A Financing terms form the basis for all future rounds**

- Customary Terms:
 - Common vs. Preferred Stock
 - Valuation
 - Liquidation Preferences/Participating Preferences
 - Dividends
 - Conversion Rights and Anti-Dilution Protection
 - Preemptive Rights
 - Redemption Rights
 - Protective Provisions
 - Board Structure
 - Registration Rights
 - Information Rights
 - Rights of First Refusal and Co-Sale

- Common Stock v. Preferred Stock
 - Convertible Preferred Stock is the financing vehicle of choice
 - Preferred Stock provides superior rights, preferences and privileges
 - Economic terms such as liquidation preferences, conversion privileges and anti-dilution rights
 - Control provisions
 - Two-Class structure allows start-up to grant stock options at a discount to the Preferred Stock price

- Valuation
 - Determines ownership split
 - Reduced exit valuations and delayed exits can affect early stage values
 - Be realistic about the timing and prospects for, and the possible value of, a liquidity event
 - Today's valuation sets expectations for the next round of financing, so think through the implications, both positive and negative, of a current valuation offer
 - Back door pre-money valuation reductions
 - Large Pre-Money Option Pool
 - Milestone-based anti-dilution triggers
 - Milestone-based Closings
 - Disproportionate liquidation preferences
 - Cumulative Dividends
 - Warrants

- Liquidation Preferences/Participating Preferences
 - Liquidation Preference is the right to receive proceeds upon liquidation (including sale of company) before any distribution to common shareholders
 - Seniority over junior preferred stock and common
 - Super liquidation preference (e.g., 3x preference off the top) are NOT common; typically only used in recaps
 - Participating Preference is the right to participate in the distribution of the remaining proceeds (after payment of the Liquidation Preference) on a pro rata basis with the Common Stock
 - Fully participating with no cap (i.e., full participation right) becoming more prevalent way to increase potential returns on winners
 - Try to cap participation (e.g., 3x the original purchase price)

Venture Financing



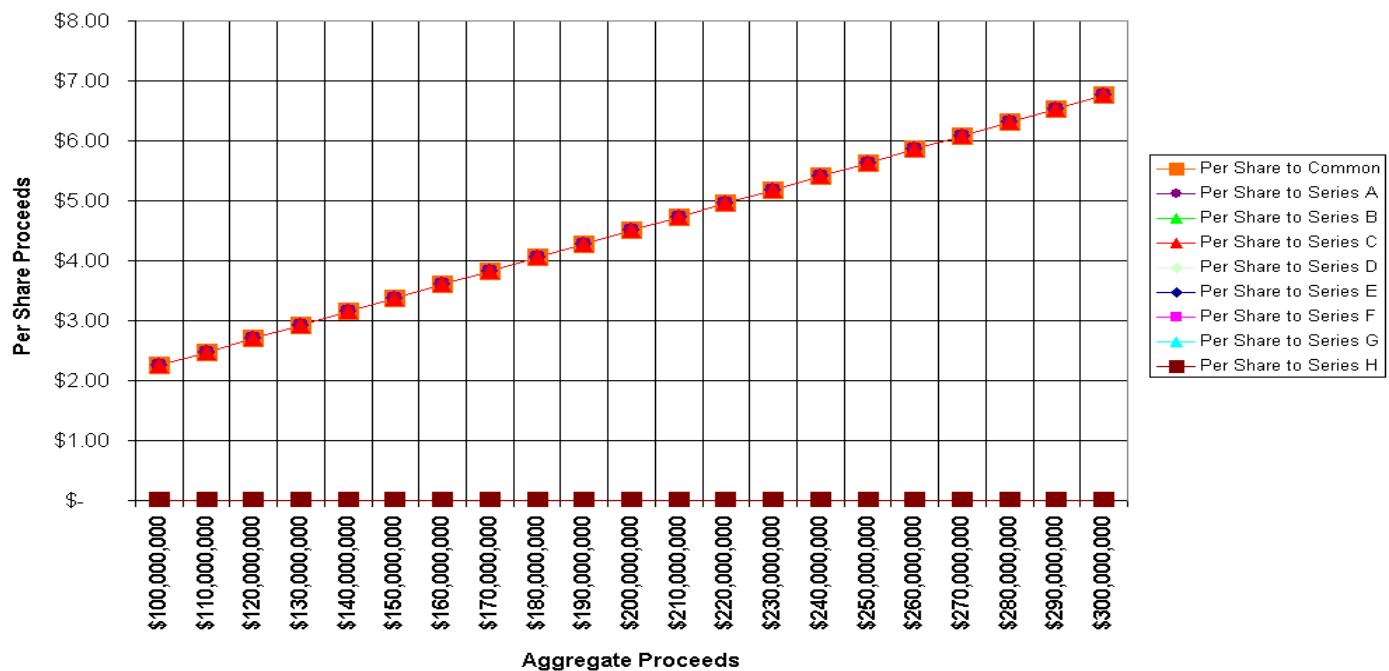
Example 1 - Liquidation Preference only; No Participating Preference

Series	\$ 100,000,000.00	\$ 110,000,000.00	\$ 120,000,000.00	\$ 130,000,000.00	\$ 140,000,000.00	\$ 150,000,000.00	\$ 160,000,000.00
Aggregate to Common	\$ 29,271,593.23	\$ 32,198,752.57	\$ 35,125,911.90	\$ 38,053,071.24	\$ 40,980,230.57	\$ 43,907,389.90	\$ 46,834,549.24
Aggregate to Series A	\$ 17,611,873.37	\$ 19,373,060.71	\$ 21,134,248.05	\$ 22,895,435.39	\$ 24,656,622.73	\$ 26,417,810.07	\$ 28,178,997.41
Aggregate to Series B	\$ 19,783,200.99	\$ 21,761,521.06	\$ 23,739,841.12	\$ 25,718,161.19	\$ 27,696,481.26	\$ 29,674,801.33	\$ 31,653,121.40
Aggregate to Series C	\$ 33,333,332.41	\$ 36,666,665.67	\$ 39,999,998.92	\$ 43,333,332.18	\$ 46,666,665.44	\$ 49,999,998.70	\$ 53,333,331.96
Aggregate to Series D	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series E	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series F	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series G	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series H	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Per Share to Common	\$ 2.25	\$ 2.48	\$ 2.71	\$ 2.93	\$ 3.16	\$ 3.38	\$ 3.61
Per Share to Series A	\$ 2.25	\$ 2.48	\$ 2.71	\$ 2.93	\$ 3.16	\$ 3.38	\$ 3.61
Per Share to Series B	\$ 2.25	\$ 2.48	\$ 2.71	\$ 2.93	\$ 3.16	\$ 3.38	\$ 3.61
Per Share to Series C	\$ 2.25	\$ 2.48	\$ 2.71	\$ 2.93	\$ 3.16	\$ 3.38	\$ 3.61
Per Share to Series D							
Per Share to Series E							
Per Share to Series F							
Per Share to Series G							
Per Share to Series H							

Venture Financing



Example 1 - Liquidation Preference only; No Participating Preference



Venture Financing



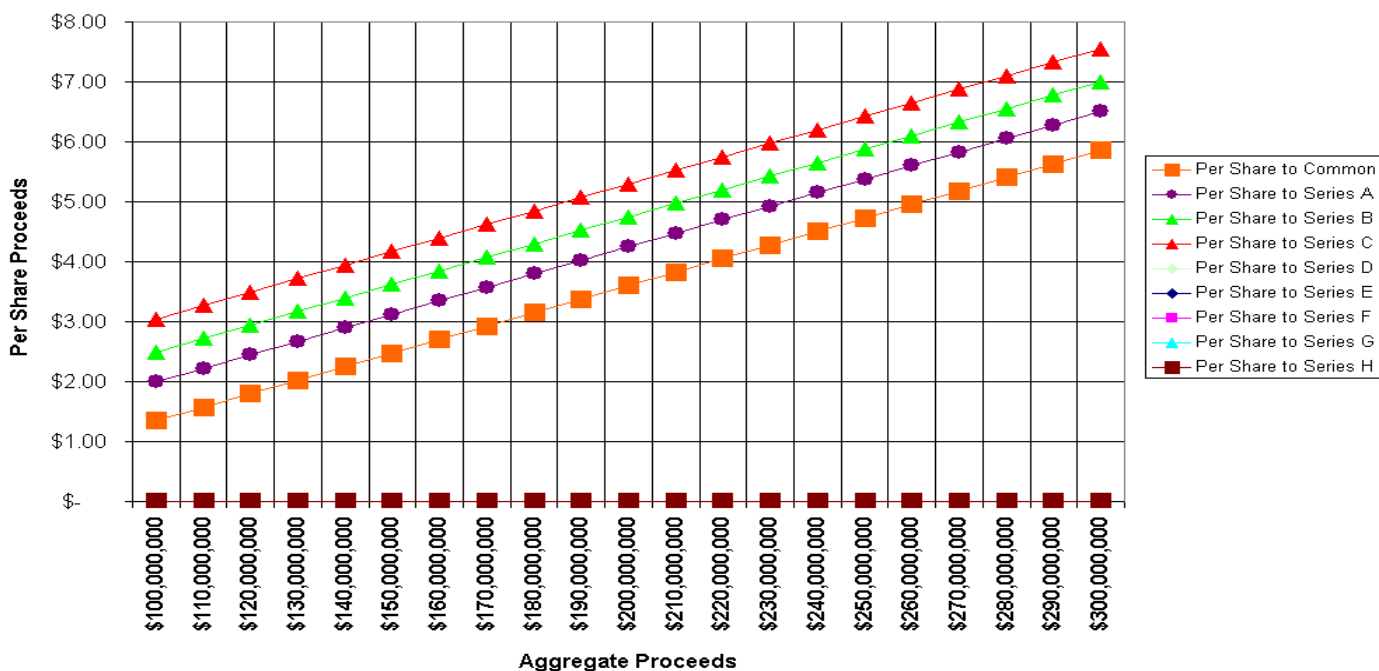
- **Example 2 - Liquidation Preference; Full Participating Preference**

Series	\$ 100,000,000.00	\$ 110,000,000.00	\$ 120,000,000.00	\$ 130,000,000.00	\$ 140,000,000.00	\$ 150,000,000.00	\$ 160,000,000.00
Aggregate to Common	\$ 17,563,161.49	\$ 20,490,320.82	\$ 23,417,480.16	\$ 26,344,639.49	\$ 29,271,798.82	\$ 32,198,958.16	\$ 35,126,117.49
Aggregate to Series A	\$ 15,567,246.67	\$ 17,328,434.01	\$ 19,089,621.35	\$ 20,850,808.69	\$ 22,611,996.03	\$ 24,373,183.37	\$ 26,134,370.71
Aggregate to Series B	\$ 21,869,951.29	\$ 23,848,271.36	\$ 25,826,591.43	\$ 27,804,911.49	\$ 29,783,231.56	\$ 31,761,551.63	\$ 33,739,871.70
Aggregate to Series C	\$ 44,999,640.55	\$ 48,332,973.81	\$ 51,666,307.07	\$ 54,999,640.32	\$ 58,332,973.58	\$ 61,666,306.84	\$ 64,999,640.10
Aggregate to Series D	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series E	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series F	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series G	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series H	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Per Share to Common	\$ 1.35	\$ 1.58	\$ 1.80	\$ 2.03	\$ 2.25	\$ 2.48	\$ 2.71
Per Share to Series A	\$ 1.99	\$ 2.22	\$ 2.44	\$ 2.67	\$ 2.89	\$ 3.12	\$ 3.35
Per Share to Series B	\$ 2.49	\$ 2.72	\$ 2.94	\$ 3.17	\$ 3.39	\$ 3.62	\$ 3.84
Per Share to Series C	\$ 3.04	\$ 3.27	\$ 3.49	\$ 3.72	\$ 3.95	\$ 4.17	\$ 4.40
Per Share to Series D							
Per Share to Series E							
Per Share to Series F							
Per Share to Series G							
Per Share to Series H							

Venture Financing



Example 2 - Liquidation Preference; Full Participating Preference



Venture Financing

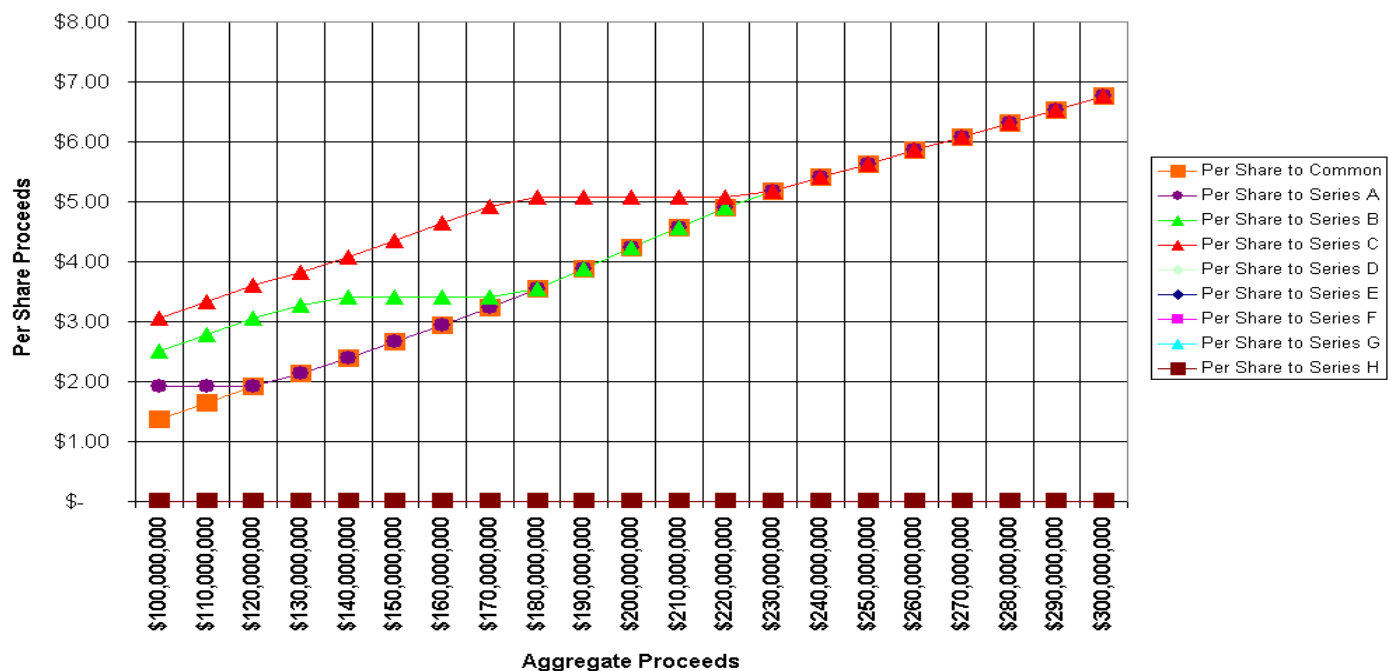


- **Example 3 - Liquidation Preference; Participating Preference with 3x Cap**

Series	\$ 100,000,000.00	\$ 110,000,000.00	\$ 120,000,000.00	\$ 130,000,000.00	\$ 140,000,000.00	\$ 150,000,000.00	\$ 160,000,000.00
Aggregate to Common	\$ 19,800,461.57	\$ 23,648,736.11	\$ 27,297,796.36	\$ 30,735,346.47	\$ 33,662,505.80	\$ 36,589,665.13	\$ 39,516,824.47
Aggregate to Series A	\$ 12,539,060.93	\$ 14,228,762.43	\$ 16,424,296.72	\$ 18,492,571.47	\$ 20,253,758.81	\$ 22,014,946.15	\$ 23,776,133.49
Aggregate to Series B	\$ 20,113,088.12	\$ 20,192,849.26	\$ 20,192,849.26	\$ 20,772,478.33	\$ 22,750,798.39	\$ 24,729,118.46	\$ 26,707,438.53
Aggregate to Series C	\$ 47,547,389.38	\$ 51,929,652.20	\$ 56,085,057.66	\$ 59,999,603.74	\$ 63,332,937.00	\$ 66,666,270.26	\$ 69,999,603.52
Aggregate to Series D	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series E	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series F	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series G	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Aggregate to Series H	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Per Share to Common	\$ 1.52	\$ 1.82	\$ 2.10	\$ 2.37	\$ 2.59	\$ 2.82	\$ 3.04
Per Share to Series A	\$ 1.61	\$ 1.82	\$ 2.10	\$ 2.37	\$ 2.59	\$ 2.82	\$ 3.04
Per Share to Series B	\$ 2.29	\$ 2.30	\$ 2.30	\$ 2.37	\$ 2.59	\$ 2.82	\$ 3.04
Per Share to Series C	\$ 3.22	\$ 3.51	\$ 3.79	\$ 4.06	\$ 4.28	\$ 4.51	\$ 4.73
Per Share to Series D							
Per Share to Series E							
Per Share to Series F							
Per Share to Series G							
Per Share to Series H							

Venture Financing

Example 3 - Liquidation Preference; Participating Preference with 3x Cap



- Dividends
 - Cumulative vs. non-cumulative
 - Non-cumulative dividends are only paid when declared by the Board
 - Never paid because start-ups are cash starved
 - Cumulative dividends accrue like interest on a note and get added to the liquidation preference
 - Payable upon liquidation or conversion
 - Increase the investor's return and decrease proceeds payable to common stock

- Conversion Rights and Anti-Dilution Protection
 - Conversion Rights
 - Preferred Stock typically is convertible into Common Stock at a 1:1 ratio (Preferred Stock Price/Conversion Price)
 - Allows investor to have virtually unlimited upside by converting to Common Stock in connection with an acquisition or IPO
 - Convertible at any time at the option of the investor
 - Automatically convertible in certain circumstances
 - Conversion feature allows for implementation of price-based anti-dilution protection

– Anti-Dilution Protection

- Price-based anti-dilution provisions adjust the conversion ratio of the Preferred Stock upon triggering events (down round, missed milestone, etc.)
 - For example, the conversion ratio may adjust to 2:1 because the conversion price (the denominator) is adjusted to a lower number (1/.5)
- VC Terms should provide for customary exclusions from the anti-dilution provisions
 - Option pool, strategic investments, charitable causes, lending transactions, etc.

- Types of Anti-Dilution Provisions:
 - Full ratchet
 - » Adjusts the conversion price to the price at which the dilutive security was sold (See Article for example)
 - » Most investor-favorable; harsh results
 - Weighted average: Broad-based vs. Narrow-based
 - » Broad-based still the most common
 - » Adjusts the conversion price after taking into account the current shares outstanding and the number of shares sold at the dilutive price
 - » Broad-based weighted average formula:

$$NCP = CP * \left[\frac{CSO + \left(\frac{NM}{CP} \right)}{CSO + AS} \right]$$

Where:

NCP = New Conversion Price

CP = Current Conversion Price

CSO = Common Stock Outstanding on a Fully Diluted Basis (excluding unissued options)

NM = New Money Raised

AS = Additional Shares Issued for New Money

Venture Financing



		Percentage Ownership
Fully-Diluted Outstanding Value (pre-money)	\$5,087,940	36.12%
New Money	\$9,000,000	63.88%
Fully-Diluted Outstanding Value (post-money)	\$14,087,940	100.00%

New Investor \$ Amount

	Pre-Series C Closing		Post-Series C Closing		Post-Reverse Split (1 for 50)		Post-Dividend Warrants		Post-Split/Post Warrants	
	Shares	Percent	Shares	Percent	Shares	Percent	Shares	Percent	Shares	Percent
Common Stock	3,038,592	22.8%	3,038,592	0.53%	60,772	0.53%	3,038,592	0.53%	60,772	0.53%
Dividend Warrants							11,517,168	2.00%	230,343	2.00%
Common Stock Warrants	24,124	0.2%	726,129	0.13%	14,523	0.13%	726,129	0.13%	14,523	0.13%
Option Pool (exercised)	249,839	1.9%	249,839	0.04%	4,997	0.04%	249,839	0.04%	4,997	0.04%
Option Pool outstanding	1,212,356	9.1%	1,212,356	0.21%	24,247	0.21%	1,212,356	0.21%	24,247	0.21%
Option Pool available	1,877,805	14.1%	1,877,805	0.33%	37,556	0.33%	1,877,805	0.33%	37,556	0.33%
Option Pool Increase			140,614,375	24.42%	2,812,287	24.42%	140,614,375	24.42%	2,812,287	24.42%
Series A Preferred Stock	3,811,041	28.7%		0.00%	-	0.00%	-	0.00%	0	0.00%
Series A Warrants	26,000	0.2%	26,000	0.00%	520	0.00%	26,000	0.00%	520	0.00%
Series A-1 into Common			2,066,855	0.36%	41,337	0.36%	2,066,855	0.36%	41,337	0.36%
Series A-2 into Common			39,318,293	6.83%	786,366	6.83%	30,834,873	5.35%	616,697	5.35%
Series B Preferred Stock	3,049,813	22.9%		0.00%	-	0.00%	-	0.00%	0	0.00%
Series B Warrants	10,000	0.1%	10,000	0.00%	200	0.00%	10,000	0.00%	200	0.00%
Series B-1 into Common			2,582,682	0.45%	51,654	0.45%	2,582,682	0.45%	51,654	0.45%
Series B-2 into Common			14,060,579	2.44%	281,212	2.44%	11,026,831	1.91%	220,537	1.91%
Series C Preferred Stock			370,074,911	64.26%	7,401,498	64.26%	370,074,911	64.26%	7,401,498	64.26%
Total (fully diluted)	13,299,570	100.0%	575,858,416	100.00%	11,517,168	100.00%	575,858,416	100.00%	11,517,168	100.00%

Series C Financing	Money	Shares	Post-Split
Price per share	\$0.024725		\$1.2362
New Investment	\$ 9,000,000	364,008,132	7,280,163

Anti-dilution adjustments	Pre-split	Post-split	Post-warrants
Post-Series C first close			
Series A conversion price pre-Series C	\$1.72000	\$86.00000	\$86.00000
Series A conversion price post-Series C	\$0.07630	\$3.81502	\$4.86462
Series A conversion ratio post-Series C	22.54248907	22.54248907	17.67866142
Series B conversion price pre-Series C	\$8.56290	\$428.14500	\$428.14500
Series B conversion price post-Series C	\$0.28448	\$14.22415	\$18.13756
Series B conversion ratio post-Series C	30.09986311	30.09986311	23.60543625

	Option Detail	Post-Split
Granted	1,462,195	29,244
Ungranted	1,877,805	37,556
Current	3,340,000	66,800
Pool Increase	140,614,375	2,812,287
	143,954,375	2,879,087

- Preemptive Rights
 - Give investors the right to purchase their pro rata share of any equity securities sold by the Company
 - Also apply to issuances of securities convertible into equity securities (e.g., convertible debt)
 - Allows investors to maintain their ownership percentage of the Company
 - May restrict the Company's ability to bring in new investors
 - Customarily have the same exclusions that apply to the anti-dilution provisions

- Redemption Rights
 - Right to require the Company to repurchase the shares after a period of time (usually 5-7 years)
 - Rarely used, but do have purpose: focusing company on liquidity event
 - Terms:
 - Sometimes includes accrued dividends (like debt)
 - Sometimes greater of fair market value or cost
 - Redemption sometimes required when reps, covenants breached
 - Time period (5-7 years vs. 3 years)
 - Shorter time periods for less certain deals
 - Structured pay-out (e.g., 3 years vs. one-time)

- **Protective Provisions**

- Provisions granting preferred stockholders special voting rights
- Board approval (including preferred directors) may be required for certain actions
- Restrictions on changes in Preferred Stock terms, or authorization/issuance of senior securities
- Sale of the company
- Can include many operational covenants or restrictions, including:
 - Hiring certain executives
 - Changing line of business
 - Increasing the option pool
 - Increasing salaries
 - Incurrence of indebtedness over certain amount
 - Capital expenditures over certain amount

- Board Structure
 - VC model is to have active participation
 - VC will insist on one or more Board seats
 - 5 Member Board, 2/2/1 structure is fairly common
 - Start-up boards meet monthly
 - Indemnification and insurance obligations

- Registration Rights
 - Give investors the right to require the Company to register shares of stock with the SEC
 - Mechanism for liquidity
 - Types:
 - Demand Registration Rights
 - “Piggyback” Registration Rights
 - S-3 Registration Rights
 - See Article for description

- Information Rights
 - Visitation rights
 - Monthly and Quarterly unaudited and annual audited financial statements
 - Management rights letter
- Rights of First Refusal and Co-Sale
 - Essentially lock up founders and prevent them from getting liquidity in front of investors
 - Maintain control over ownership of the Company's equity

- Miscellaneous
 - “Pay to Play” Provisions
 - Founder Vesting
 - Proprietary Information Agreements
 - Non-solicitation and non-compete
 - Investor’s counsel fees and expenses
 - Commercial insurance; D&O Insurance



Bootstrapping

- Take on consulting jobs to provide cash flow to fund the main business
- Work nights and weekends on the “side project”
 - Be sure to only work on your own time using your own resources
- If web app, leverage Amazon S3, EC2, etc., open source software and outsourcing



Government Funding

- <https://www.fedconnect.net/Fedconnect/>
- ARRA (the “Stimulus Act”)
 - Grants, loan guarantees, etc.
 - Usually for projects that can scale up fairly quickly
 - Must pay prevailing union wages in an area
 - Opportunities issued pursuant to well defined Funding Opportunity Announcements (“FOAs”)
 - Can be very helpful for project development
- SBIRs
- Other research grants

Funding Your Start-Up

QUESTIONS?

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Alan Bickerstaff is a Corporate and Securities partner who focuses on representing entrepreneurs and public and private emerging growth companies on formation, operations and corporate governance matters; securities law reporting and compliance matters; private equity and venture capital financings; public offerings and mergers and acquisitions.

Alan represents companies in a wide variety of industries, including the software, cleantech, internet, energy, semiconductor, renewable energy, life sciences, and telecommunications industries.

Alan has also represented numerous institutional investors in venture capital financings and private equity transactions as well as underwriters in various public securities offerings.

Alan has represented companies, venture capitalists and private equity sponsors in raising over \$600 million in capital in more than 100 venture capital and private equity financings. He has advised companies and underwriters in raising over \$2 billion in capital through initial public offerings, public equity and debt offerings and Rule 144A transactions, acquirers and targets in over \$2 billion of public and private company merger and acquisition transactions.

ANDREWS KURTH LLP Technology and Emerging Companies Group

Andrews Kurth's Technology and Emerging Companies Group is a leading business law firm for entrepreneurs, emerging growth companies and venture capital and private equity investors. Our attorneys develop business structures, help to secure financing, take companies public, advise on acquisition and strategic alliances, counsel on executive compensation, and help our clients protect their intellectual property.

We represent clients in the areas of clean technology/renewable energy, semiconductors, telecommunications, computers and electronics, enterprise software, life sciences, aerospace, Internet and e-commerce, consumer products and retail. We also represent and have extensive contacts with market leading investment banking, private equity and venture capital firms from coast-to-coast.



Appendix A

- **Pre-Money Valuation** – the value of the business before any investment by an outside party
 - Possible to avoid / defer through the use of convertible bridge loans
- **Post-Money Valuation** – the value of the business after the completion of an investment by an outside party
- **Common Stock** – the most basic form of stock representing the residual value of the company; held by founders and employees
- **Founder's Stock** – these are the shares of common stock that founders of company purchase or typically receive at the creation of the company, usually for very low value (e.g. \$0.001 per share)
- **"Reverse" Vesting** – a mechanism to provide for time-based vesting, *often imposed by an investor after the fact*, to permit a company to repurchase a decreasing percentage of shares of founder's stock over time based on a vesting schedule

Key Terms



- **Option Pool** – a portion of the company’s outstanding stock set aside for use as incentive compensation for present and future employees. Allocated and unallocated amounts and required increases included in pre-money valuation
- **Preferred Stock** – a form of stock usually held by investors with certain rights and preferences superior to those of common stock, including liquidation preference, redemption and anti-dilution rights, and governance, voting and board rights and restrictions
- **Liquidation Preference** – the right of preferred stock holders to receive the value of their investment before any other liquidation distributions are made to other equity holders. Sometimes includes “participation” provision for the preferred stock to continue to share proceeds with the common
- **Antidilution Rights** – the right of preferred stock holders to maintain its fractional ownership percentage if shares are later issued at a lower valuation

- **Preemptive Rights** – the right of investors to purchase their pro rata share of any future equity issuances
- **Registration Rights** – the right of investors to require the company to register their shares with the SEC for sale into public markets

The materials included herein provide a general description of certain legal and business matters and should not be construed as providing specific legal advice or establishing an attorney-client relationship.

AUSTIN TECHNOLOGIES, INC.

SUMMARY OF TERMS FOR SERIES A PREFERRED STOCK FINANCING

May 1, 2008

This is a summary, for negotiation purposes only, of the principal terms of the proposed sale and issuance of Series A Preferred Stock by Austin Technologies, Inc., a Delaware corporation (the “*Company*”), to certain individuals and entities (the “*Investors*”). Except as set forth under the caption “Non-Solicitation,” which shall be binding on the Company and the Investors upon execution of this summary of terms, this summary of terms is not intended to be a binding agreement between the Company and the Investors.

GENERAL TERMS OF THE FINANCING

Security: Series A Preferred Stock (“*Series A*”)¹.

Aggregate Offering: \$5,000,000.

Purchase Price Per Share: \$1.0714 (the “*Series A Original Purchase Price*”).

Number of Shares: 4,666,791.

Pre-Money Valuation: \$7,500,000.

<i>Investors:</i>	<u>Name:</u>	<u>Amount:</u>
	AT Ventures	\$2,500,000
	SV Ventures	\$2,500,000
	Other Investors	\$0

Expected Closing Date: May 30, 2008.

Capitalization: The Company’s capitalization before the sale of the Series A and after the sale of the Series A is set forth below:

	<u>Pre-Financing</u>		<u>Post-Financing</u>	
	<u>Number of Shares</u>	<u>%</u>	<u>Number of Shares</u>	<u>%</u>
Common Stock	5,000,000	80%	5,000,000	42.86%
Stock Option Plan (1)	1,250,000	20%	2,000,000	17.14%
Series A Preferred	—	—	4,666,791	40.00%
Totals:	6,250,000	100%	11,666,791	100%

(1) An aggregate of 1,250,000 shares of Common Stock have been reserved for issuance pursuant to the stock option plan. Of the number shown, 20,000 shares are subject to outstanding options and 1,230,000 shares remain available for future grant.

¹ Any reference to “Preferred” in this Summary of Terms refers to the Series A Preferred Stock.

RIGHTS, PREFERENCES AND PRIVILEGES OF THE SERIES A

- Dividends:* The holders of the Series A will be entitled to receive in preference to the Common Stock (“**Common**”), noncumulative dividends of 8.0% of the Series A Original Purchase Price per annum when, as and if declared by the Company’s Board of Directors (the “**Board**”). Thereafter the Series A and Common will share any dividends declared by the Board pro-rata on an as-converted to Common basis.
- Liquidation Preference:* In the event of any liquidation, dissolution or winding up of the Company, the holders of the Series A will be entitled to receive in preference to the holders of Common, a per share amount equal to the Series A Original Purchase Price plus any declared but unpaid dividends. All remaining assets available for distribution will be distributed ratably to the holders of Common. Unless otherwise determined by a majority of the Preferred, a merger or sale of substantially all of the assets of the Company will be treated as a liquidation, dissolution or winding up for purposes of the liquidation preference.
- Conversion:*
- Conversion.* Each holder of Series A will have the right to convert its shares of Series A at any time into shares of Common at the then applicable conversion rate. The conversion rate shall initially be 1:1, and shall be subject to antidilution adjustment as described below.
- Automatic Conversion.* The Series A will be automatically converted into Common upon (i) the approval of the holders of a majority of the then outstanding Preferred or (ii) the closing of a firm commitment underwritten public offering of the Company’s Common in which the aggregate gross proceeds to the Company equals or exceeds \$10,000,000 at a per share price of at least three (3) times the Series A Original Purchase Price (subject to proportionate adjustment for future stock splits, dividends or combinations).
- Antidilution Protection:*
- Stock Splits & Combinations.* Proportional adjustments will be made to the conversion rate of the Series A for stock splits, stock dividends and stock combinations of the Common.
- Price-based Protection.* The conversion rate of the Series A will be subject to adjustment, on a broad-based weighted average basis, in the event the Company issues additional shares at a purchase price per share less than the Series A Original Purchase Price, other than shares issued to employees, officers, directors, consultants, advisors or service providers pursuant to a plan or arrangement approved by the Board, and other customary exclusions (collectively, the “**Excluded Shares**”).
- Redemption:* Upon the election of the holders of a majority of then outstanding Series A made at any time after the fifth anniversary of the date of the initial closing of the sale and issuance of Series A, the Company will

redeem the Series A in three equal annual installments at a price per share equal to the Series A Original Purchase Price plus declared but unpaid dividends.

Voting:

Generally. The holders of Series A will have the right to that number of votes equal to the aggregate number of shares of Common issuable upon conversion of such holder's shares of Series A.

Election of Directors. The Company's Board will consist of five (5) directors. The holders of Common, voting as a separate class, will be entitled to elect two members of the Company's Board, initially to be Founder 1 and Founder 2. The holders of Series A, voting as a separate class, will be entitled to elect two members of the Company's Board, one of which shall be designated by AT Ventures and one of which shall be designated by SV Ventures. All remaining members of the Board will be elected by the Common and Preferred, voting together as a single class.

Protective Provisions. So long as fifty percent (50%) of the Preferred issued by the Company is outstanding, the Company will not without first obtaining the affirmative vote or written consent of the holders of more than fifty percent (50%) of the outstanding Preferred: (i) take any action that would materially and adversely alter or change the rights, preferences or privileges of any series of Preferred then outstanding, (ii) authorize any new class or series of equity securities which is superior to or on a parity with any preference or priority of any series of Preferred then outstanding, (iii) amend the Company's certificate of incorporation, (iv) change the size of the Board of Directors or (v) amend the Company's existing stock option plans or adopt a new stock option plan.

INVESTORS' RIGHTS AGREEMENT

Registration Rights:

Demand Rights. If, at any time after earlier of (i) the fourth anniversary of the date of first sale of Series A or (ii) six (6) months after the Company's initial public offering, the holders of at least a majority of the Common issuable upon conversion of the Preferred (the "**Registrable Securities**") request that the Company file a registration statement covering at least 40% of such Registrable Securities (or a lesser percentage provided the aggregate offering price to the public, net of discounts and commissions, exceeds \$10,000,000), the Company will use its reasonable efforts to cause such Registrable Securities to be registered. The Company will not be obligated to affect more than one registration under these demand right provisions.

“Piggyback” Registration. Holders of Registrable Securities will be entitled to “piggyback” registration rights on all registrations effected by the Company, subject to the right of the Company and its underwriters to reduce the number of shares that such holders propose to be registered to the extent required by such market conditions. Any such provisions will provide that at least 25% of the total amount of shares included in the registration will be Registrable Securities (except that a full cut-back would be permitted upon the Company’s initial public offering), and employees and other selling stockholders must be cut back fully before the holders of Registrable Securities will be cut back.

S-3 Demand Right. If available for use by the Company, the holders of Registrable Securities will be entitled to five (5) S-3 registrations provided that the anticipated aggregate offering price, net of discounts and commissions, would exceed \$1,000,000. This right may not be used more than once in a twelve-month period.

Expenses. The registration expenses (exclusive of underwriting discounts and commissions and expenses of legal counsel to any selling stockholders) of the registrations will be borne by the Company.

Other. Registration rights terminate four years after consummation of the Company’s initial public offering or earlier as to a particular holder of Registrable Securities if such holder can sell all of its shares of Registrable Securities in a 90 day period pursuant to Rule 144. The registration rights may be transferred to a transferee that acquires at least 250,000 shares of Registrable Securities.

Information Rights:

So long as an Investor holds 250,000 shares of Preferred, the Company will deliver quarterly unaudited and annual audited financial statements. The obligation of the Company to furnish such information will terminate upon the earliest to occur of (i) the Company’s initial public offering, (ii) the Company becoming subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, or (iii) a merger or sale of substantially all of the assets of the Company.

Preemptive Rights:

Each holder of Preferred will have preemptive rights to purchase such holder’s pro rata portion of any new securities issued by the Company subsequent to the sale and issuance of the Series A, other than Excluded Shares. To the extent such preemptive right is not exercised by a Preferred holder, such right will be transferred to the other holders of Preferred who have elected to exercise their preemptive rights. This right will terminate upon the earlier to occur of (i) the Company’s initial public offering or (ii) a merger or sale of substantially all of the assets of the Company.

Market Standoff:

All holders of Series A agree not to sell any shares of the Company’s Common for 180 days following the closing of the Company’s initial

public offering, provided the Company's officers, directors and greater than five percent (5%) stockholders enter similar agreements.

RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT

Right of First Refusal:

The Company will be entitled to a right of first refusal on any proposed transfer by Founder 1 and Founder 2 (the "**Founders**"), subject to customary exceptions for transfers in connection with estate planning, bona fide loan transactions and sales up to 5% of the total number of shares of capital stock held by a Founder. To the extent not exercised by the Company, the right of first refusal will be transferred to the holders of Series A on a pro rata basis.

Co-Sale Rights:

The holders of Series A will have the right to participate on a pro rata basis in transfers of stock for value by any Founder, subject to customary exceptions for transfers in connection with estate planning, bona fide loan transactions and sales up to 5% of the total number of shares of capital stock held by a Founder.

Termination:

The right of first refusal and co-sale right will terminate upon the earlier to occur of (i) the Company's initial public offering or (ii) a merger or sale of substantially all of the assets of the Company.

OTHER MATTERS

Representations and Warranties:

The purchase of the Series A will be made pursuant to a Stock Purchase Agreement drafted by [_____], the Company's corporate counsel, which agreement will contain standard representations and warranties typically given in a venture capital financing and appropriate conditions of closing which will include, among other things, qualification of the shares under applicable Blue Sky Laws, the filing of a Certificate of Incorporation and an opinion of counsel.

Founders' Vesting:

Seventy-five percent (75%) of the shares of the Company's Common owned by Founder 1 and Founder 2 will be subject to the Company's repurchase option in the event that such individual is no longer affiliated with the Company. Such repurchase option will lapse ratably each month such that the shares will be fully vested in four years.

Stock Option Plan:

Grant of options or sale of Common to employees will be pursuant to a stock option plan administered by the Board. Options or stock granted under any such plan will vest twenty-five percent (25%) after one year's employment with the Company and one forty-eighth ($\frac{1}{48}^{\text{th}}$) per month thereafter.

Employees:

All employees will enter into confidential information and invention assignment agreements containing provisions with respect to confidentiality, corporate ownership of inventions during employment, non-solicitation of employees and customers during and for one year

after employment and non-competition during and for one year after employment.

Expenses:

The Company will bear its legal expenses; in addition, the Company will pay the reasonable legal fees and expenses of one counsel to the Investors up to a maximum of \$30,000.

Non-Solicitation:

From the date of the execution of this summary of terms by the parties hereto until the earlier of (i) the closing of the sales and issuance of the Series B or (ii) the expiration of 30 days from the date of execution of this summary of terms by the parties hereto, the Company will not directly or indirectly solicit, initiate, or participate in any discussions or negotiations with, or encourage or respond to any inquires or proposals by any person or group other than Investors, concerning any financing of the Company.

This summary of terms may be executed in counterparts, each of which is deemed an original, all together constituting one and the same instrument.

“Company”

By: _____

Its: _____

“Investors”

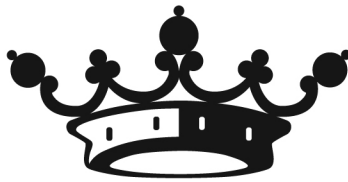
By: _____

Its: _____

I N S I D E T H E M I N D S

Analyzing VC Deal Terms

*Leading Lawyers on Structuring Term Sheets,
Developing Negotiation Strategies, and
Assessing Risks*



ASPATORE

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An Entrepreneur's Guide to Venture Capital Financing Terms

Alan Bickerstaff

Partner

Andrews Kurth LLP



Introduction: The VC Lawyer's Role

I am a corporate and securities attorney focused on representing venture capital firms, investment banks, entrepreneurs, and public and private technology and emerging growth companies in a variety of industries, including clean technology/renewable energy; Internet and social media; software; wireless; telecommunications; semiconductor; life science; and medical device and nanotechnology companies. I have completed over 150 venture capital (“VC”) financings, public offerings, and acquisitions involving technology and emerging growth companies at Wilson Sonsini Goodrich & Rosati and Andrews Kurth LLP.

An experienced VC lawyer should be an integral part of the management team at any start-up company and should have a practical, business-like approach to advising start-up companies. An experienced VC lawyer has focused expertise and therefore can provide invaluable assistance to an entrepreneur, from a legal perspective and a non-legal perspective. He or she adds value from a non-legal perspective by making introductions to venture capitalists, other sources of capital and other service providers with start-up expertise and by providing guidance and information on various trends and deal terms known to the VC lawyer by virtue of being part of the start-up ecosystem. A VC lawyer adds value from a legal perspective by proactively steering the start-up through the organization and financing processes and identifying and solving issues early in the financing process in order to avoid last minute complications. Moreover, because of a VC lawyer's focused expertise, he or she should be more efficient and effective in providing legal services to start-up companies.

With respect to VC financings, an experienced VC lawyer should be able to clearly explain in practical terms the provisions relating to four areas:

- Valuation and the economics of VC deal terms
- Founder vesting schedules
- Control issues, including board structure
- Market terms for the other more technical aspects of the VC financing

Introduction to VC Financings

The overwhelming majority of VC financings use convertible Preferred Stock as the financing vehicle. Investors prefer convertible Preferred Stock for various reasons, including the fact that the rights, preferences, and privileges of Preferred Stock are superior to Common Stock. This two-class structure aids a start-up in recruiting employees in that it also allows for Common Stock options to be granted to employees of the Company at a price that is discounted to the Preferred Stock because the rights, preferences, and privileges of Preferred Stock make it more valuable in the market than Common Stock. The terms of VC financings are fairly customary, with nuances unique to each deal and geographic region. For example, East Coast VCs tend to require founders personally to make certain representations and warranties whereas this practice is virtually nonexistent in West Coast deals.

Generally speaking, there is an expectation of speed, efficiency, and simplicity with respect to the venture capital financing process. Typically, the principals on both sides of a VC financing focus on a small group of core issues at the term sheet stage, including valuation, liquidation and participating preferences, founder vesting, and control issues, such as board structure. Once the term sheet has been executed, the principals generally expect that the parties will not expend significant resources or time negotiating the definitive agreements.

Terms of a VC Financing

Customary terms in a VC financing include: (i) the economic terms, such as valuation, founder vesting schedules, dividends, liquidation preferences, conversion rights, preemptive rights, and anti-dilution provisions; (ii) control provisions, such as various protective provisions, voting rights, rights of first refusal and co-sale, voting agreements, and board structure; and (iii) various contractual rights, such as registration rights, information rights, and various covenants. Following is a brief overview of these terms.

Valuation

Valuation is typically the term most focused on by entrepreneurs and VCs alike because it determines how the ownership in the company will be divided. Founders prefer a higher valuation in order to retain a larger ownership stake in the company. VCs generally prefer a lower valuation for the same reason—to obtain a larger stake in the company, which in turn may result in a higher return on investment for the VC and its limited partners. Founders should be aware that too high of a valuation initially may make it more difficult to get a higher valuation in the next round of financing, or even worse, result in a lower valuation, which may make another round of financing difficult to achieve. VCs must be mindful of the fact that forcing founders to give up too much ownership initially due to a low valuation may demoralize the founders as subsequent rounds of financing continue to dilute their equity stake. The founders may come to feel that there is nothing left on the table for them after years of hard work creating a valuable company.

Typical valuation drivers include a developed product; referenceable customers; revenue; large addressable market size; strong management team; required capital to break even; industry specifics/competitive landscape; proprietary technology/barriers to entry; and public market/M&A market multiples.

Founder Vesting

VCs want to ensure that the founders have incentive to stick around for the long haul to provide a substantial contribution to the company's value, so VCs insist upon imposing vesting on the founders' stock in the company. A customary founder vesting schedule provides for vesting of the founder's stock over a four-year period. The vesting schedule may take various forms, including: (i) monthly vesting over four years; (ii) 25 percent vesting up front, no vesting for one year and then monthly vesting thereafter for three years; or (iii) 25 percent vesting up front and monthly vesting thereafter for four years. Founders will typically also be entitled to some amount of accelerated vesting upon certain events. For example, a founder might negotiate to receive 25 percent or more vesting upon an acquisition of the company or a termination without cause ("single trigger" accelerated

vesting) or 25 percent or more vesting if (i) the company is acquired and (ii) the founder is terminated in connection with, or within a certain period of time following, the acquisition (“double trigger” accelerated vesting).

Dividends

Given that start-ups are typically cash starved, they virtually never pay cash dividends. Indeed, I personally have never seen or even heard of an emerging growth company paying cash dividends to its investors. Start-up companies require all the cash they have on hand, and then some, to fund development and growth. Nevertheless, VC term sheets typically have a dividend provision providing for either cumulative or non-cumulative dividends. Non-cumulative dividends are paid at a specified rate “when, as and if declared by the board of directors,” which generally means that dividends do not accrue (like interest on a promissory note); the board of directors must declare a dividend before it will be paid. Practically speaking, non-cumulative dividends are never paid because they are not declared by the board of directors. Cumulative dividends typically accrue at a specified rate (similar to interest on a promissory note), whether or not declared by the board, and are paid at a future date. In VC deals, cumulative dividends will typically be added to the liquidation preference and get paid upon the acquisition of the company or the conversion of the Preferred Stock into Common Stock. Of course, this increases the return on investment for the VC and decreases the amount of proceeds from an acquisition available to the common stockholders. For this reason, founders generally prefer non-cumulative dividends while, all else being equal, VCs generally would prefer cumulative dividends.

Liquidation Preference/Participating Preference

Traditional VC Preferred Stock customarily has a liquidation preference, meaning that the Preferred Stock is paid its liquidation preference if the company is acquired or liquidated before the Common Stock is entitled to any proceeds from the acquisition or liquidation. The liquidation preference of Preferred Stock is generally equal to the price paid for the Preferred Stock. For example, if a VC paid \$0.50 per share for Series A Preferred Stock, the liquidation preference would be \$0.50 per share. Thus, if the company sold \$5 million of Series A Preferred Stock, the company would

have to be acquired for a price greater than \$5 million before the Common Stock would receive any proceeds from the acquisition because the first \$5 million of proceeds would be distributed to the holders of the Series A Preferred Stock. Let's assume the Series A Preferred Stock represented 20 percent of the fully diluted capitalization of the company and that the holders of Common Stock owned the remaining 80 percent of the company. If the company were acquired for \$20 million, the proceeds would be distributed as follows:

- The first \$5 million would be distributed to the holders of Series A Preferred Stock
- The remaining \$15 million would be distributed to the holders of Common Stock

Often VC Preferred Stock will also provide an additional return known as a participating preference. Generally, a participating preference provides that after the holders of Preferred Stock have received the full payment of the liquidation preference to which they are entitled, the holders of Preferred Stock will then be entitled to participate in the distribution of the remaining proceeds from an acquisition or liquidation of the company on a pro rata basis with the holders of Common Stock. Continuing the example from above, let's assume the Series A Preferred Stock also had a fully participating preference. If the company were acquired for \$20 million, the proceeds would be distributed as follows:

- The first \$5 million would be distributed to the holders of Series A Preferred Stock
- The remaining \$15 million would be distributed to the holders of Series A Preferred Stock and the holders of Common Stock on a pro rata basis according to their ownership in the company as follows:
 - o the holders of Series A Preferred Stock would receive an additional \$3 million of the proceeds (20% x \$15 million)
 - o the holders of Common Stock would receive \$12 million of the proceeds (80% x \$15 million)

As you can see, the participating preference provided additional return to the holders of Series A Preferred Stock at the expense of the holders of the Common Stock when compared to the first example. A variation of the participating preference places a cap so that beyond a certain point (three times the original purchase price, for example), the Preferred Stock will stop participating in the proceeds distributed. These are simplified examples meant to illustrate liquidation preferences and participating preferences and how they impact the distribution of proceeds from an acquisition. The actual distribution of proceeds in an exit event often requires a much more complex analysis, particularly when multiple series of Preferred Stock are part of the capital structure.

Conversion Rights and Anti-Dilution Protection

VC Preferred Stock is typically convertible into Common Stock, initially at a 1:1 ratio, at any time at the option of the holder. VC Preferred Stock is customarily convertible in order to allow the investor to have virtually unlimited upside by converting to Common Stock and participating in an acquisition of the company or an initial public offering. The conversion feature also allows for the implementation of price-based anti-dilution protection for the investor. Price-based anti-dilution provisions adjust the conversion ratio of the Preferred Stock in the event that the company sells capital stock for a price lower than the Preferred Stock purchase price (in connection with a “down round,” for example) in order to provide some price protection to investors.

Anti-dilution provisions generally come in two flavors: full-ratchet anti-dilution and weighted average anti-dilution. Full-ratchet anti-dilution is the most investor-friendly flavor because the conversion price of the Preferred Stock “ratchets down” to the lower price, even if only one share of stock is issued at the lower price. Weighted average anti-dilution is the most founder-friendly because the conversion price is lowered after taking into account how many shares are issued at the lower price. Thus, if only a few shares are issued, the conversion price will not change much. For example, if the company issues Series A Preferred Stock at a price of \$0.50 per share, the conversion ratio for the Series A Preferred Stock will be $.50/.50$ and the conversion price (the denominator) will be $.50$. Let's assume the company then sells one hundred shares of capital stock for a price of \$0.25 per share.

With full-ratchet anti-dilution, the conversion price would be reduced to .25 and the Series A Preferred Stock would then be convertible into two shares of Common Stock ($.50/.25=2$). With weighted average anti-dilution, the conversion price would barely budge and would likely be something like .499999 and each share of Series A Preferred Stock would be convertible into slightly more than one share of Common Stock (1.000002 shares in this example). The formula for weighted average anti-dilution is a fairly complicated algebraic equation and is beyond the scope of this article, but the foregoing should give you a sense of the difference between these two approaches.

Recognizing that there are circumstances in which it is in the best interests of the company and the investors that capital stock may be issued at a price lower than the Preferred Stock purchase price without triggering an anti-dilution adjustment, anti-dilution provisions provide for customary carve-outs for certain issuances. For example, start-up companies grant stock options with very low exercise prices as an incentive to employees and management. Investors recognize that it is in their best interests that management be motivated and therefore these option grants are customarily carved out and will not trigger anti-dilution adjustments. Other issuances that customarily will not trigger an anti-dilution adjustment include issuances to banks or equipment lessors in connection with debt financing transactions, issuances of securities to OEMs or other partners in connection with licensing or strategic partnering transactions and issuances of securities in a public offering.

Preemptive Rights

Preemptive rights give investors the right to purchase their pro rata share of any equity securities sold by the company so that the investors may maintain their ownership percentage in the company. Preemptive rights may restrict the company's ability to bring in new investors. The preemptive rights provisions customarily provide for the same carve-outs for certain issuances that are provided in the anti-dilution provisions.

Redemption

It is fairly customary for VC Preferred Stock to have redemption rights. In a fairly typical formulation, redemption rights give the holders of Preferred Stock the right to cause the company to repurchase their shares at a pre-determined price—often the original purchase price of the Preferred Stock plus accrued or declared but unpaid dividends. Redemption rights provide a mechanism for investors to get liquidity in a situation where the company does not appear likely to either be acquired or go public—companies that are sometimes called the “walking dead.” This tends to be a fairly rare situation, so redemption provisions are very rarely ever used. Investors prefer to have these provisions nonetheless as a back-stop method to force liquidity for their investment.

Protective Provisions

Protective provisions require the company to obtain the consent of a specified percentage of the holders of the Preferred Stock prior to effecting certain corporate transactions. These provisions are largely defensive provisions designed to protect investors from having unfavorable transactions forced upon them. Examples of transactions that would require the approval of the holders of Preferred Stock prior to consummating the transaction include:

- Amending the rights, preferences or privileges of the Preferred Stock
- Engaging in a transaction that would result in the acquisition of the company
- Authorizing or issuing new securities that would be senior to or equal to the existing series of Preferred Stock with respect to the rights, preferences, and privileges of the securities
- Changing the size of the board of directors
- Authorizing new equity compensation plans or amending existing plans

Board Structure

The VC model is typically one in which the VCs expect to have active participation in the management of the company. To accomplish this, investors will typically insist upon one or more board seats in order to have some control over the direction of the company. A fairly typical board of directors for an early stage VC-backed company would be a five-member board with two directors designated by the investors, two directors designated by the common stockholders, one of which will typically be the CEO, and one director who is an independent director. The board of directors will usually meet on a monthly basis to closely monitor the company's development.

Registration Rights

Registration rights give investors the right to require the company to register their shares of stock in order to allow the investors to achieve liquidity on their investment. These provisions are fairly customary and usually there is not much time spent negotiating the details of the registration rights provisions. Registration rights provisions in a VC financing customarily provide for the following types of registration rights:

- Demand Registration Rights. Demand registration rights allow the investors to cause the company to initiate an initial public offering four to six years following the venture financing. Although this may sound draconian, the practical reality is that a company may only go public if the public markets are favorable and the company's business is showing significant growth. For these reasons, these rights are very rarely ever exercised by financial investors.
- "Piggyback" Registration Rights. Piggyback registration rights give investors the right to include their shares of stock in a company-initiated registration, subject to certain provisions that allow the company to reduce the number of shares that investors may include in the offering.
- S-3 Registration Rights. S-3 registration rights are a form of demand registration rights, but they may be exercised only after the company is eligible to use a type of short-form

registration statement available to companies that have been public at least a year and meet certain other criteria.

Information Rights

In order to ensure that they have adequate access to information regarding the company, VCs customarily receive contractual information rights that require the company to provide monthly and quarterly unaudited and annual audited financial statements, as well as rights to access the company's premises and books and records.

Rights of First Refusal and Co-Sale

Rights of first refusal give investors the right to purchase shares of Common Stock that a founder proposes to sell to a third party, on the same terms as proposed by the third party. Rights of Co-Sale give investors the right to cut back the founder and sell the investor's shares alongside the founder's shares to the third party on the same terms. The objective of these provisions is to effectively lock up the founders to keep them from obtaining liquidity before the investors do and to keep tight control over ownership of the company's equity.

Conclusion

An effective VC attorney will establish the proper relationship with the lawyers and principals on the other side in a VC financing. Effective counsel always takes a practical, business-like approach to negotiations, while staying focused on achieving the client's objectives. Given that the terms of VC financings are fairly customary, it does not make sense to negotiate over every single point. Rather, the focus should be on the handful of provisions that are truly important and on the main objective of getting the deal done. Compromise and reasonableness will go a long way in negotiations, and will help get the relationship of the principals off to a good start. Creating an adversarial relationship during negotiations does not benefit either party and may drag out the process and increase transaction costs. An adversarial relationship during negotiations may also create ill feelings between principals who will for all practical purposes be partners for some time after the VC financing has closed.

Alan Bickerstaff is a corporate and securities partner in the Austin, Texas office of Andrews Kurth LLP. He has a passion for working with entrepreneurs and helping them build start-up companies and has been doing it for over eight years. He represents venture capital firms, investment banks, and public and private technology and emerging growth companies on general corporate and transactional matters, including securities law reporting and compliance, formation and corporate governance issues, private equity and venture capital transactions, public offerings, and mergers and acquisitions.

Mr. Bickerstaff has advised clients in raising more than \$450 million in venture capital, helped execute more than \$2.4 billion worth of public offerings and Rule 144A transactions, and represented clients in mergers and acquisitions totaling more than \$2.7 billion in value.



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