The Basics of Conducting a Securities Offering: Regulatory Overview

Presented by the Middle Market and Small Business Committee

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Eric A. Vendt; Whiteford, Taylor & Preston LLP; Falls Church, VA
David M. Lynn; Morrison & Foerster LLP; Washington, DC
Bonnie J. Roe; Cohen & Gresser LLP; New York, NY
Josh Seidenfeld; Cooley LLP; Palo Alto, CA

BUSINESS LAW | BASICS

AMERICAN BAR ASSOCIATION
Business Law Section

Securities Act Basics

Basic Concept of the 1933 Act

- Every offer or sale of securities using the U.S. mails or interstate commerce is either:
  - ***Registered***
  - ***Exempt***
  - ***Illegal***

What do you "register"?

- You register **transactions**.
- You do **NOT** register securities.
- You **neve**r say *"The securities were registered."*
- There is **no** such thing as a ***"registered security"*** or a ***"free trading security"*** under the Securities Act.

1933 Act Section 5 – Registration

- **Section 5(c)** – may not offer a security unless a registration statement has been filed.
- **Section 5(b)(1)** – any written offers, TV offers or radio offers made after filing must include the information required by Section 10 (***Spoiler alert*** – free-writing prospectuses).
- **Section 5(a)** – no sales before the registration statement becomes effective.
- **Section 5(b)(2)** – final prospectus must accompany or precede the delivery of the security after sale.
- **Section 2(a)(3)** – an "offer" is "every attempt or offer to dispose of, or solicitations of offers to buy, a security or interest in a security for value."

What is “gun jumping”?

- Offers prior to filing the registration statement…
  - Securities Act Release No. 33-5180
  - Rule 135
  - Rule 163
  - Rule 163A
  - Rule 168
  - Rule 169
  - Section 5(d)

What is “gun jumping”?

- Written offers after filing the registration statement other than through the Section 10 prospectus
  - Rule 134
  - Free-writing prospectus

Is an exemption available?

- The person claiming the exemption has the burden of showing the availability of the exemption.
- **"Keeping in mind the broad remedial purposes of federal securities regulation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable."**
- SEC v. Ralston Purina Co. 346 U.S. 119 (1953).

"Types" of Exemptions

- The terms ***"securities"*** exemptions and ***"transactional"*** exemptions are just for reference.
- ***You always have to determine whether there is an exemption for the transaction.***

"Types" of Exemptions

- "***Securities" exemptions*** – it is the nature of the securities that provides the basis for exempting the transaction.
- Examples:
  - Section 3(a)(1) through Section 3(a)(8)
  - Section 3(a)(13)

"Types" of Exemptions

- ***"Transactional" exemptions*** – it is the nature of the transaction that provides the basis for exempting the transaction.
- Examples:
  - Section 3(a)(9) through Section 3(a)(12)
  - Section 4(a)(1) through Section 4(a)(6)

"Private Placements"

- Section 4(a)(2)
  - "Transactions by an issuer not involving any public offering."
  - SEC v. Ralston Purina – the number of offerees is a factor, but not the determinative factor.
- Courts – look to:
  - The number of offerees;
  - The offerees' need for information;
  - The offerees' access to information; and
  - The size of the offering.
- SEC – also looks to whether there was any "public advertising."

Regulation D

- Safe harbors/exemptions under Section 3(b) and Section 4(a)(2)
- Four exemptions:
  - Rule 504;
  - Rule 505;
  - Rule 506(b); and
  - Rule 506(c).
- Key terms:
  - "Accredited Investor."
  - "General Solicitation" (and how the internet fits with this).

Other Stuff About Exemptions

- Employee Benefit Plans for Non-Public Companies
  - Rule 701
- Offerings outside the United States
  - Not actually an “exemption”
  - Regulation S

Other Stuff About Exemptions

- "Integration"
  - 5-Factor Test
  - Concurrent Public and Private Offerings
  - Safe harbors
  - Rule 152

"Underwriter" and "Resales"

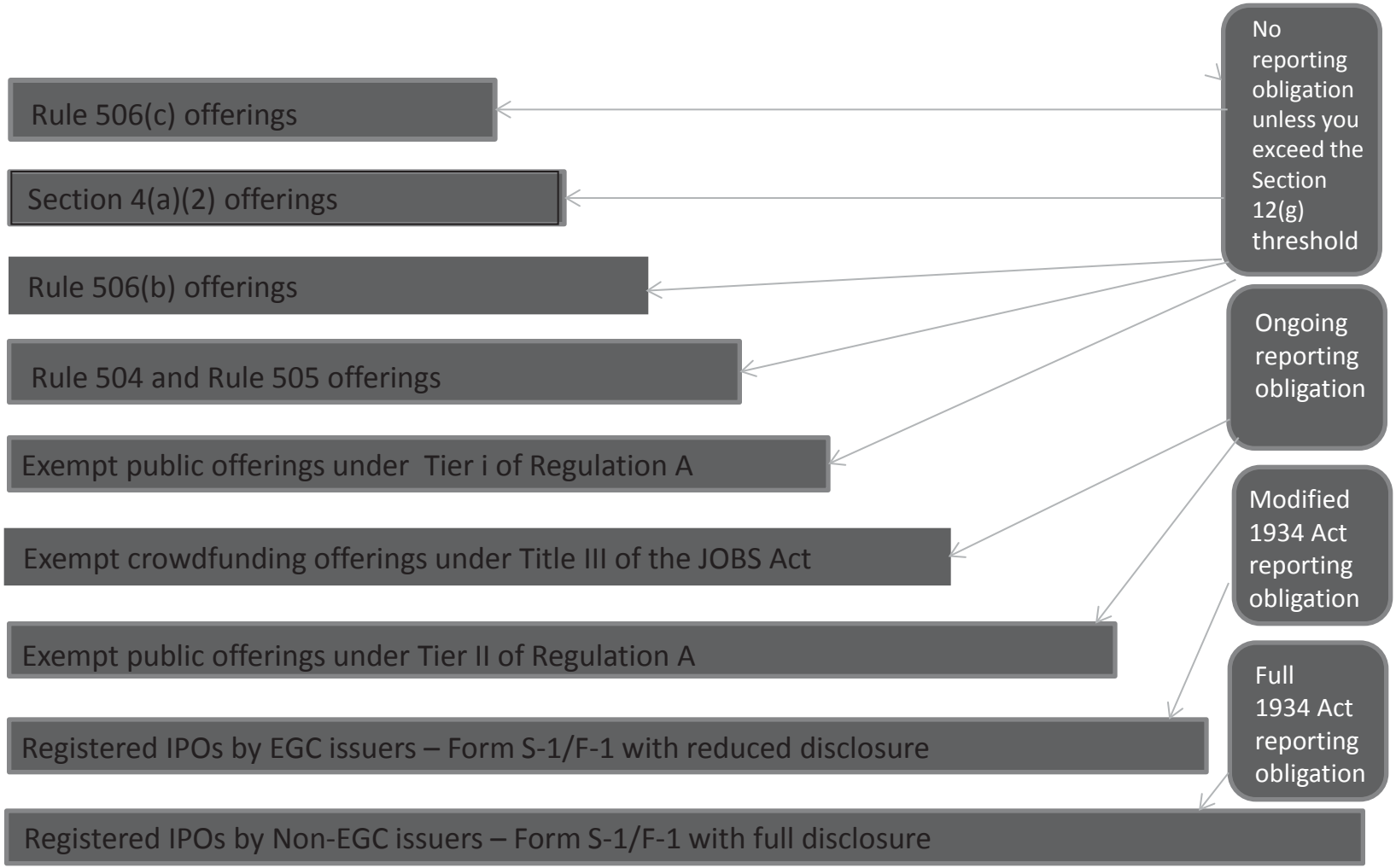
- Section 4(a)(1)
  - "Affiliate"
- Section 2(a)(11)
- Rule 144
  - "Control Securities"
  - "Restricted Securities"

"Illegal"

- Section 11
  - Strict Liability for Registration Statements
  - Defined List of Actors
  - "Due Diligence"
- Section 12(a)(1)
- Section 12(a)(2)
  - "Reasonable Investigation"
- Section 17(a)

Impact of the JOBS Act

Offering Alternatives After the JOBS Act



Regulation D

General Solicitation

- Rule 506(c) of Regulation D now permits the use of general solicitation subject to the following conditions:
  - The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
  - All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons who qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
  - The conditions of Rules 501, 502(a) and 502(d) are satisfied.
- Offerings may still be conducted under Rule 506(b) without using general solicitation and it is not necessary to verify accredited investor status.

Verification

- Rule 506(c) provides principles-based guidance on how to verify accredited investor status, highlighting that the inquiry to be undertaken may differ depending on the facts and circumstances. The SEC provides a list of factors to consider:
  - *The nature of the purchaser*. The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, wealthy individuals and charities;
  - *The nature and amount of information about the purchaser*. Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa"; and
  - *The nature of the offering*. The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status, *i.e.,* issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email.

Verification

- Rule 506(c) provides a supplemental non-exclusive list of methods that may be used to satisfy the verification requirement with respect to individual accredited investors, including:
  - A review of IRS forms for the two most recent years and a written representation regarding the individual's expectation of attaining the necessary income level for the current year;
  - A review of bank statements, brokerage statements, tax assessments, etc. to assess assets, and a consumer report or credit report from at least one consumer reporting agency to assess liabilities;
  - A written confirmation from a registered broker-dealer, RIA, CPA, etc.; or
  - For existing investors (pre-Rule 506(c) effective date), a certification.

Choosing a Rule 506 Exemption

- Issuers at an earlier stage appear more likely to use general solicitation, and these may be issuers that have not retained a financial intermediary.
- A third-party verification service can be especially useful in this case given that it is likely to be accustomed to handling financial information and the issuer should:
  - Consider whether the third-party verification service is a registered broker-dealer or a registered investment adviser; and
  - Conduct diligence regarding the third-party verification service and its procedures.
- If the issuer proposes to undertake the verification process on its own, the issuer should implement special procedures and consult with counsel.

Crowdfunding

Crowdfunding

- Title III of the JOBS Act provides an exemption that could apply to crowdfunding offerings.
  - The SEC voted to release proposed rules on October 23, 2013, and the deadline for comments on the proposed rules expired on February 3, 2014.
  - The SEC's proposed rules track the statute closely.
- The aggregate amount sold to all investors by the issuer should not be more than $1,000,000.
  - This includes any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction.
- The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction, should not exceed:
  - The greater of $2,000 or 5 percent of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; or
  - 10 percent of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.

Crowdfunding (cont'd)

- The transaction must be conducted through a broker or "funding portal."
- Information should be filed and provided to investors regarding the issuer and offering, including financial information based on the target amount offered.
- The provision prohibits issuers from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker, and requires disclosure of amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.

Crowdfunding Proposal

- The SEC's proposed rules have proven controversial
  - Crowdfunding proponents believe that the proposal is too burdensome and would make it challenging for start-ups
    - Process requirements are too prescriptive and cumbersome
    - Disclosure requirements for the initial offer (Form C) and ongoing reporting requirements (Form C-A, Form C-U, Form C-AR) would make the process to expensive
  - By contrast, the SEC's Investor Advisory Committee has recommended stronger consumer protection provisions

In the meantime…

- The SEC staff issued various Compliance and Disclosure Interpretations regarding intrastate crowdfunding
- Various states have adopted their own crowdfunding exemptions

Regulation A

Regulation A – The "Mini-IPO"

- The SEC recently adopted amendments to Regulation A which:
  - Amend and modernize existing Regulation A.
  - Create two tiers of offerings:
    - Tier 1 for offerings of up to $20m ($6m for selling stockholders); or
    - Tier 2 for offerings of up to $50m ($15m for selling stockholders).
  - Set issuer eligibility, disclosure and reporting requirements.
  - Impose additional disclosure and ongoing reporting requirements, as well as an investment limit, for Tier 2 offerings, and, given these investor protection measures, makes Tier 2 offerings exempt from certain blue sky requirements.
  - Are effective 60 days after publication of the final rules in the Federal Register.

Offering Limitations

- **Tier 1** - an issuer may offer and sell up to $20 million in a 12-month period, of which up to $6 million may constitute secondary sales (except as noted below).
- **Tier 2 -** an issuer may offer and sell up to $50 million in a 12-month period, of which up to $15 million may constitute secondary sales (except as noted below).
- In the issuer's initial Regulation A offering and any Regulation A-exempt offering in the 12 months following that offering, the selling securityholder component cannot exceed 30% of the aggregate offering.

Investment Limitations

- A non-accredited natural person is subject to an investment limit and must limit purchases to no more than 10% of the greater of the investor's annual income and net worth, determined as provided in Rule 501 of Regulation D (for non-accredited, non-natural persons, the 10% limit is based on annual revenues and net assets).
- The investment limit does not apply to accredited investors and will not apply if the securities are to be listed on a national securities exchange at the consummation of the offering.
- Investors must be notified of the investment limitations.
- An issuer can rely on a representation from the investor.

Offering Circular

- Regulation A offering statements must be filed on EDGAR.
- Periodic reports and any other documents required to be submitted to the SEC in connection with a Regulation A offering must be filed on EDGAR.
- As proposed, the final rules adopt an access equals delivery model for Regulation A final offering circulars.
- When a preliminary offering circular is used to offer securities to potential investors by a non-reporting issuer, the issuer and participating broker-dealer will be required to deliver the preliminary offering circular to prospective purchasers at least 48 hours in advance of sales.

Confidential Review

- An issuer may submit an offering statement for non-public review by the SEC.
- As with EGCs, should an issuer opt for confidential review, the offering statement must be filed publicly not less than 21 calendar days before qualification of the offering statement.
  - The timing, in the case of a Regulation A offering, is not tied to an issuer's road show, but rather to the qualification of the offering statement.
  - The SEC noted specifically that the 21-day public filing period will provide state securities regulators an opportunity to assure filing of offering materials at the state level in advance of an offering under Regulation A.

Testing-the-Waters

- An issuer may solicit any investors (not subject to the requirements applicable to EGCs, for example)
- Materials may be used both before and after the offering statement is filed
  - Subject to certain disclaimer requirements
  - Subject to antifraud and civil liability provisions
  - Materials used after an offering statement is publicly filed, would be required to be accompanied by a preliminary offering statement (or a link to the offering statement)
  - An issuer might be required to redistribute any test the waters material in order to correct the materials
  - Material would be required to be filed with the SEC and would be publicly available

Ongoing Reporting

- Tier 1 issuers would have no ongoing reporting obligation, other than to file an exit report on Form 1-Z within 30 days after the termination or completion of a Regulation A-exempt offering.
- Tier 2 issuers will be subject to ongoing reporting. As a result, it is likely that an issuer considering a Tier 2 offering will engage in a cost-benefit analysis and consider its objectives and aim to raise the full $50 million

State Law Requirements

- The final rules provide that Tier 1 offerings will remain subject to state securities law requirements.
- Tier 2 offerings will not be subject to state review if the securities are sold to “qualified purchasers” or, as provided by statute in the JOBS Act, listed on a national securities exchange.
- The final rule defines the term “qualified purchaser” in a Regulation A offering to include all offerees and purchasers in a Tier 2 offering.

Coordinated Review

- NASAA established the Coordinated Review Program for Regulation A Offerings to facilitate the filing of Regulation A offerings in multiple U.S. jurisdictions.
- Pursuant to the review protocol, a lead merit and a lead disclosure examiner will be appointed to manage the review of the offering.
- If the issuer is not applying for registration in a state that applies merit standards, then only a lead disclosure examiner will be appointed.
- The participating jurisdictions use the applicable NASAA statements of policy as modified by the review protocol.

The IPO On-Ramp

Emerging Growth Company

- An EGC is defined as an issuer with total annual gross revenue of less than $1 billion (with such threshold indexed to inflation every five years).
- An EGC would retain that status until:
  - The last day of the fiscal year in which the issuer had $1 billion or more in annual revenues;
  - The last day of the fiscal year following the fifth anniversary of the issuer's IPO;
  - The date on which the issuer has, during the previous rolling 3-year period, issued more than $1 billion in non-convertible debt:
    - Debt *issued* in a public or an exempt offering (not outstanding);
    - Rolling three-year period from the time the issuer establishes its EGC status; *or*
  - The date when the issuer is deemed to be a "large accelerated filer" (as defined by the SEC).

Emerging Growth Company – Benefits

- Permits filing a registration statement with the SEC on a confidential basis.
- Expands the range of permissible pre-filing communications made to qualified institutional buyers, or QIBs, or institutional accredited investors.
- EGCs may now engage in oral or written communications with QIBs and institutional accredited investors in order to gauge their interest in a proposed IPO (i.e. “test-the-waters”) either prior to or following the first filing of the IPO registration statement.
- Requires EGCs to provide only two years of audited financial statements to the SEC (rather than three years), and delays the auditor attestation on internal controls requirement.
- Exempts EGCs from:
  - The mandatory say-on-pay vote requirement;
  - The Dodd-Frank Act-required CEO pay ratio rules, and permits the use of certain smaller reporting company scaled disclosure;
  - Any new or revised financial accounting standard until the date that such accounting standard becomes broadly applicable to private companies; and
  - Any rules requiring mandatory audit firm rotation or a supplement to the auditor’s report that would provide additional information regarding the audit of the company’s financial statements (no such requirements currently exist).

EGC Accommodations

- The market has grown progressively more comfortable with the EGC accommodations
- Confidential submissions:
  - Almost universally adopted-depending on statistics you review, just over 90%
  - Usually two confidential submissions prior to the first public filing
  - Much of the discussion related to process now often focuses on the timing of flipping from confidential submission to first public filing, often based on:
    - Getting the 21-day period to run in order to meet the IPO roadshow schedule
    - The desire to pursue a dual-track process
  - Other questions that arise in connection with confidential submission
    - What is required to be contained in the submission
    - When do the prior submissions and exhibits become public
  - Can a foreign issuer elect EGC status and opt to use the confidential submission process for FPIs?

EGC Accommodations (cont'd)

- Disclosure patterns
  - Financial information: two versus three years of financial information
    - There has been increased adoption of the two-years of financials approach
    - Considerations: what trends will need to be illustrated and discussed? What will bankers want to present in the road show?
  - Executive compensation disclosures: almost universal adoption of reduced disclosure
- Extended phase-in for Section 404(b): almost universal adoption
- Phase-in for new GAAP policies: almost all EGCs have chosen not to take advantage of the extended phase-in

EGC Accommodations (cont'd)

- Testing the waters
  - There was early reluctance to take advantage of the ability to engage in these submissions; however, depending on the sector, there has been some greater acceptance
  - Timing of discussions
  - Use of written materials
- Pre-deal Research and Research Practices
  - Pre-deal research remains rare
  - A 25-day "quiet period" has been memorialized in AAUs
  - More willingness to conduct joint diligence sessions that include research and banking

Representing the Issuer in a Non-Institutional Capital Raise: A Basic How-To

COHEN & GRESSER LLP

Overview of the Topics:

What we'll cover

- Due Diligence and Disclosure
- The Subscription Package and Investor Questionnaires
- Offering Procedures and the Use of Brokers
- Terms of the Security, Restrictions on Transfer and Other Agreements with Investors (a brief overview)
- Documents You'll See

Due Diligence and Disclosure: *Why?*
Part I

- Access to information concerning the issuer is a key element in the basic private placement exemption under Section 4(a)(2) of the Securities Act
- Access to information is also key under other exemptions
  - For unaccredited investors, information is required for offerings under Rule 506(b)
  - Financial information is required under Rule 701, which is the exemption for offerings to employees
  - Information may also be required for state Blue Sky exemptions

Due Diligence and Disclosure: *Why?*
Part II

- Decisions concerning investments are made based on information, and investors will get and rely on information from the issuer and possibly others
- Having a formalized process of providing information gives some assurance that the information that investors get is reliable and provides a record of the information they had access to
- Rule 506(b) for accredited investors—no particular information requirement, but you must avoid fraud
- Disclosure is an insurance policy for the issuer

Due Diligence and Disclosure: *What?*
Part I

- Traditionally issuer's counsel would prepare a private placement memorandum or offering circular for a private placement, and that is still the case in many deals
- In other deals, it is perhaps more useful to talk about the "information package", which could come in several parts:
  - Slide deck prepared by the issuer
  - Risk factors drafted by counsel
  - Financial statements distributed when they are ready
  - Deal documents perhaps distributed in drafts
  - Information about capitalization and use of proceeds might be included in the deal documents and perhaps reiterated in a chart provided to investors

Due Diligence and Disclosure: *What?*
Part II

- In many deals there is little guidance as to what to disclose, how much to disclose or how basic do you make the disclosure—how much should you assume that investors already know.
- If you get to know an industry and a particular type of deal, you can get a feel for what investors expect, and also what types of problems are typical
  - Does the company own its IP?
  - Are there regulatory issues that it faces, or licenses that it needs?
  - Is there litigation or a substantial contingent liability?
  - Are there issues with the cap table—for example, questions about how many shares or options are outstanding?

Due Diligence and Disclosure: *What?*
Part III

- One basic question the issuer's counsel should ask: what is there about the issuer that investors will want to have known about before they invested? (Due diligence and disclosure as insurance policy)
- The other basic question: does the exemption I am relying on requires specific information?
  - Rule 506(b) offering that includes unaccredited investors requires information equivalent to an offering circular under Regulation A or an S-1 registration statement
  - Rule 701 has various financial statement requirements
- "Bad Actor" disclosure or disqualification for Rule 506 offerings

The Subscription Package and Investor Questionnaires
Part I

- Typically investors agree to purchase securities by signing a subscription agreement and answering a questionnaire about themselves
- What the questionnaire covers will depend on the circumstances, but some basics are:
  - Questions to determine whether the investor is accredited (a series of specific questions about income and assets, type of entity, etc., not just check the box that the investor is accredited)
  - Smaller investors often invest through an entity that is or may be an accredited investor because all of its equity owners are accredited investors. For such an entity, you need information from each equity owner

The Subscription Package and Investor Questionnaires
Part II

- If you use Rule 506(c) as the exemption for your offering, you will need to do more due diligence on your investors to meet the requirement of taking “reasonable steps to verify” that natural persons purchasing in the offering are accredited investors
- For Blue Sky purposes, you will also need to know where the person lives
- Other things to worry about:
  - Investor as “bad actor”
  - Money-laundering
  - Regulated entities
  - Non-U.S. regulation (if company or investor is outside U.S.)

Offering Procedures and the Use of Brokers
Part I

- Regulated broker-dealers are often not used in non-institutional offerings—the offering requires a lot of work, but the commission is smaller than they find acceptable
- Non-registered brokers—"finders"—sometimes offer their services to help locate capital
  - Narrow and confusing SEC no-action letter relief allowing the use of an unregistered broker who merely acts as a matchmaker and is not otherwise involved in the transaction
  - Possible securities law (and Blue Sky law) violation, and possible rights of rescission if an unregistered broker is deemed to be acting as a broker
- A company's officers or directors can also be deemed to be acting as a broker if they get special compensation for helping to raise money—need to review the Rule 3a4-1

Offering Procedures and the Use of Brokers
Part II

- Who can the issuer approach in a private offering?
  - Friends and family
  - Contacts of the officers and directors
  - Other potential investors the company might have a prior relationship with (existing investors, significant customers or suppliers)
  - Angel networks if they are genuinely “personal networks” of accredited investors – see recent CDIs
  - Investors whose accredited status has been previously confirmed by an online offering platform -- follow procedures complying with recent *Citizen VC* no-action letter
- Practice point: need to discuss and establish procedures with your issuer client to make sure the issuer and people working on behalf of the issuer avoid general solicitation and general advertising
- Integration: consider whether recent offerings conducted by the issuer have an impact on the availability of your exemption

Terms of the Security, Restrictions on Transfer and Other Agreements with Investors
Part I

- Typical securities that might be issued: common stock; preferred stock; convertible notes; warrants; and LLC interests
- Except (generally) for common stock, each of these securities will require some drafting and probably some negotiation with investors
  - Consider whether and how carefully you need to describe the terms to the company client or to investors, depending on their level of sophistication
- The company will also need investors to agree not to transfer their securities in a way that would jeopardize the private offering exemption by redistributing the securities to other investors
- The company usually wants more extensive restrictions on transfer, largely to control who and how many people own the securities

Terms of the Security, Restrictions on Transfer and Other Agreements with Investors
Part II

- Some typical terms, often in a stockholders agreement
  - Right of first refusal
  - Tag-along
  - Drag-along
  - Company sale
  - Pre-emptive rights

Documents You'll See
(Wrapping Up from the Beginning)

- Non-disclosure agreements with broker and prospective investors
- Placement agent agreement if using a broker
- An information package
- A subscription package
- The basic deal documents: charter and bylaws or LLC Agreement; terms of securities (note, preferred stock, warrants, etc.); stockholder agreement
- Board and stockholder/existing equity holder authorizations
- Blue Sky filings if the offering is not exempt
- Form D if you are using Rule 506
- State filings of Form D and consent to service of process for a Rule 506 offering

Representing the Issuer in a Venture Capital Financing: A Basic How-To

September 30, 2015

attorney advertisement

3175 Hanover Street, Palo Alto, CA 94304

Cooley

Sources and Types of Funding

Cooley LLP

Sources of Funding:

- Friends and Family
- Angel Investors
- Venture Capital Investors

We will focus on Angel Investors and Venture Capital Investors

Angel and Venture Capital Investors traditionally invest in Companies by purchasing equity (ownership)

Due Diligence and Disclosure

- Angel Investors and Venture Capitalists are generally accredited investors and therefore, most offerings to these investors are completed under Rule 506(b).

Under Rule 506(b)

- The issuer must decide what information to give to accredited investors, as long as they are not committing fraud under the securities laws.

  Practice Point: Investors usually have a pre-determined checklist of items they are interested in reviewing in order to make a prudent investment decision.

- The issuer must be available to answer questions from the investors; and

- Financial statement requirements remain unchanged from Rule 505.

Disclosure Continued

- "Bad Actor" Rules
  - Who is required/disclosure/representations and warranties/covenants?
- Bureau of Economic Analysis Filings
  - BE-13
  - BEA-10
  - Any others?
- Accredited Investor Status
  - Questionnaires/representations and warranties

Information Package – Venture Financings

Cooley LLP

- Typically, diligence is conducted electronically via a virtual data room.
- "Lead" Investor will send a request list, generally covering the following:
- Board and Stockholder actions and minutes
- Charter documents
- Capital stock, including ledgers, special rights and terms
- Legal and regulatory, including litigation and other judgements, decrees, settlements, etc.
- Intellectual property, form agreements, assignments, opinions of counsel, patents, copyrights, trademark schedules
- Management, employees and consultants
- Debt financing
- Other agreements, including capital leases, real property, partnerships, and term sheets
- Miscellaneous, including any limitations on the business, business plan, investor presentation and environmental matters

Offering Process – Before the Term Sheet

Cooley LLP

- Unsolicited business plans = fail
- Third-party validation is the most successful method used, including friends and family, legal counsel, money managers, university connections and other institutions that venture investors interact with regularly.
- Once introductions are made, investors will request meetings if there is any interest, followed by additional meetings to other managers of the fund.
- Diligence and Term Sheet negotiation are the final steps before drafting definitive transaction documents.

Key Concerns and Issues

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Investors:

Return, Control and Liquidity

Founders:

Valuation, Control and Vesting

Key Concepts in a Venture Capital Transaction

Cooley LLP

- **TYPE OF SECURITY.** Companies typically sell convertible preferred stock to investors, which provides a preference payment to the preferred stock in the event the company is acquired or otherwise liquidated, and other preferences over the common stock held by the founders. These preferences help justify a much higher price for the preferred stock than the price paid by founders for the common stock.
- **PRICE/VALUATION.** Investors use a number of different methods to determine a company's valuation and the price they will pay for their investment, from a discounted revenue stream approach based on business plan projections, to a more arbitrary figure based on a desire to own a predetermined percentage of the company in return for the anticipated level of funding needed to achieve a certain milestone. Important considerations in valuation discussions are what number of shares should be reserved for an employee equity plan and whether these shares should be treated as if they were outstanding prior to the investment for purposes of calculating the price per share to be paid by investors.

Key Concepts in a Venture Capital Transaction

Cooley LLP

- **LIQUIDATION PREFERENCE -**Upon sale or liquidation of the company, the preferred stock will receive a certain fixed amount before any assets are distributed to the common stock
  - Non-participating
  - Fully Participating
  - Capped Participation
- **DIVIDEND PREFERENCE.** Generally, a dividend must be paid to the preferred stock before any dividend is paid to the common stock.
  - Cumulative
  - Non- Cumulative
- **REDEMPTION.**
  - Preferred stock may be redeemable, either at the option of the Company or the investors or mandatorily on a certain date, perhaps at some premium over the initial purchase price of the stock.

Key Concepts in a Venture Capital Transaction

Cooley LLP

- **ANTI-DILUTION PROTECTION.** The conversion price of the preferred stock will be subject to adjustment for diluting events, such as stock splits or stock dividends, and will probably also be subject to "price protection," which is adjustment upon future sales of stock at prices below the conversion price. Price protection can take many forms, from an extreme "ratchet" protection, which lowers the conversion price to the price at which any new stock is sold, no matter the number of shares, to a broad-based "weighted average" protection, which adjusts the conversion price based on a formula incorporating both the number of new shares being issued and their price. The issuance of a certain number of shares is generally excepted from this protection to cover anticipated issuances to key employees, consultants and directors. Additional exceptions are often available for shares issued to lenders and equipment lessors and for shares issued in connections with certain strategic transactions. Price protection is sometimes subject to a "pay-to-play" provision, which makes the continuation of such protection for a given investor contingent on that investor purchasing at least its pro-rata share of any future issuances priced below the conversion price.

Key Concepts in a Venture Capital Transaction

Cooley LLP

- **VOTING RIGHTS.** On general matters, preferred stock usually votes along with common stock and has a number of votes equal to the number of shares of common stock into which it is convertible.
  - Protective Provisions, such as amendments of the charter, mergers or creation of a new series of preferred stock, etc.
- **RIGHT OF FIRST REFUSAL.** Holders of preferred stock generally will have a right to participate, usually at up to an investor's current aggregate ownership percentage, in any future issuance of securities by the company.
- **CO-SALE RIGHT.** Preferred investors often will require founders to enter into a co-sale agreement. A co-sale right provides some protection against founders selling their interest in the company to a third party by giving investors the right to sell a portion of their stock as part of any such sale.

Key Concepts in a Venture Capital Transaction

Cooley LLP

- **REGISTRATION RIGHTS.** Preferred investors generally will receive registration rights as a part of their investment. These rights provide liquidity to investors by allowing them to require the company to register their shares for sale to the public either as part of an offering already contemplated by the Company ("piggyback rights") or in a separate offering initiated at the investors' request ("demand rights").
- **VESTING ON FOUNDERS' STOCK.** As a protection against founders leaving the company after the investment money is in, venture capitalists generally insist on some sort of "vesting" on founders' stock, so that a percentage of such stock, decreasing over time, is subject to repurchase by the company at cost if a founder's employment ends.
- **CONVERSION RIGHTS.** Preferred stock will be convertible into common stock at some conversion ratio, which is typically expressed as the initial purchase price of the preferred stock divided by a "conversion price," which initially equals the purchase price but is subject to adjustment upon the happening of certain events. Conversion is generally available at any time at the option of the stockholder and may be automatically triggered by certain occurrences, such as an initial public offering.

Departing Thoughts

- Make sure your corporate approvals are done correctly, including any potential DGCL § § 144, 157 & 161 issues.
- Ensure your client has dedicated ample time to preparing the disclosure schedule, if needed.
- Management Rights Letter - ensure VCOC compliance.
- Post-Closing matters, including 409A valuation for future stock award issuances under a 701 qualified plan, security filings (Form D and associated publicity issues), stock certificates, etc.

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