Business Transactions Solutions § 156:110

Business Transactions Solutions
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Part VI. Finance
Chapter 156. Venture Capital Financing
III. Master Forms and Clause Library
A. Series A Preferred Stock Summary of Terms
1. Complete Form with Practice Notes

§ 156:110. Series a preferred stock summary of terms—Master form with practice notes

References

[name of corporation]
Sale of Series A Preferred Stock Summary of Terms
[date]

I. Offering

A. Issuer

[name of corporation]

B. Amount of Financing

The aggregate purchase price of the securities to be issued to existing and new investors in this financing is expected to range from $*[dollar amount]* to $*[dollar amount]*.

C. Type of Security

[number] to *[number of shares]* shares of Series A Preferred Stock (the "Series A Preferred"), initially convertible into an equal number of shares of Common Stock (the "Common").

D. Price

$*[dollar amount]*

E. Pre-Financing Valuation

Outstanding Shares of Common Stock: *[number]*

Outstanding Shares of Preferred Stock: *[number]*

Warrants to Purchase Common Stock: *[number]*

Reserved for Issuance for Services: *[number]*

Existing Option Pool: *[number]*

Increase to Pool: *[number]*

Total Shares: *[number]*

Valuation at $*[dollar amount]* per share = $*[dollar amount]*

F. Use of Funds

[description]

G. Purchasers

Purchaser	**Amount of Investment**
[name]	$*[dollar amount]*
[name]	$*[dollar amount]*
[name]	$*[dollar amount]*
[name]	$*[dollar amount]*

II. Terms of Series A Preferred Stock

A. Rights, Preferences, Privileges and Restrictions

1. Dividend Provisions

The holders of the Series A Preferred shall be entitled to receive noncumulative dividends in preference to any dividend on Common at the rate of *[amount of percentage]*% of the per share purchase price per annum, when and as declared by the Board of Directors.

1. Alternative 1: Non-Cumulative Dividends Switching to Cumulative

The holders of the Series A Preferred shall be entitled to receive noncumulative dividends in preference to any dividend on Common at the rate of *[amount of percentage]*% of the per share purchase price per annum, when and as declared by the Board of Directors. If the Company is not public by *[date]*, dividends at the above rate shall become cumulative from that date and shall be payable quarterly in arrears.

1. Alternative 2: Cumulative Dividends

The holders of the Series A Preferred shall be entitled to receive cumulative dividends in preference to any dividend on Common at the rate of *[amount of percentage]*% of the per share purchase price per annum, payable upon redemption of the Series A Preferred or, at the Company's option, at anytime prior to the redemption of the Series A Preferred. The Company shall have the option to pay any accrued but unpaid dividends in cash or, if such payment is to be made after the initial registration of the Common, by issuing a number of shares of Common which have been registered for re-sale to the public equal to (i) the amount of the dividend being paid divided by (ii) the fair market value of the Common.

2. Liquidation Preference

In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of Common Stock an amount equal to the sum of (a) $*[dollar amount]* per share of Series A Preferred plus (b) all accrued but unpaid dividends on such share (the "Preferential Amount"). After the payment of the Preferential Amount to the Series A Preferred, the remaining assets or property distributable upon such liquidation shall be divided pro rata among the holders of Common.

2. Alternative 1: Participating Preferred

In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of Common Stock an amount equal to the sum of (a) $*[dollar amount]* per share of Series A Preferred plus (b) all accrued but unpaid dividends on such share (the "Preferential Amount"). After the payment of the Preferential Amount to the Series A Preferred, the remaining assets or property distributable upon such liquidation shall be divided pro rata among the holders of Common and Series A Preferred on an as-converted basis.

2. Alternative 2: Participating Preferred with Cap

In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of Common Stock an amount equal to the sum of (a) $*[dollar amount]* per share of Series A Preferred plus (b) all accrued but unpaid dividends on such share (the "Preferential Amount"). After the payment of the Preferential Amount to the Series A Preferred, the remaining assets or property distributable upon such liquidation shall be divided pro rata among the holders of Common and Series A Preferred on an as-converted basis until the holders of the Series A Preferred have also received an amount equal to *[amount of percentage]*% annum of the purchase price per share of such Series A Preferred. After payment of such additional sum, the remaining assets or property distributable upon such liquidation shall be divided pro rata among the holders of Common.

2. Alternative 3: Participating Preferred with Minimum Payment on Common

In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of Common Stock an amount equal to the sum of (a) $*[dollar amount]* per share of Series A Preferred plus (b) all accrued but unpaid dividends on such share (the "Preferential Amount"). After the payment of the

Preferential Amount to the Series A Preferred, the holders of Common shall be entitled to receive an amount per share of Common equal to the amount paid by such holder for such share of Common. After the payment of the aforesaid amounts, the remaining assets or property distributable upon such liquidation shall be divided pro rata among the holders of Common and Series A Preferred on an as-converted basis.

3. Merger, Consolidation

In the event of a merger, other corporate reorganization, sale of control, or any transaction in which all or substantially all of the assets of the Company are sold (other than a merger into a wholly-owned subsidiary), the holders of Series A Preferred and Common shall be entitled to receive in cash or securities the amount they would have received on a liquidation.

4. Conversion

The holders of the Series A Preferred shall have the right to convert the Series A Preferred, in whole or in part, at any time into shares of Common, provided that if at least *[amount of percentage]*% of the Series A Preferred is so converted the Company shall have the right to require the remainder of the Series A Preferred to be converted into Common. The initial conversion rate shall be 1:1.

5. Automatic Conversion

The Series A Preferred shall be automatically converted into Common, at the then applicable conversion rate, upon the closing of a firmly underwritten public offering of shares of Common of the Company at a per share price not less than $*[dollar amount]* per share and for a total offering of not less than $*[dollar amount]* (after deduction of underwriter commissions and expenses). All accrued but unpaid dividends on the Series A Preferred must be paid at the time of automatic conversion, either in cash or shares of Common valued at the then effective conversion price.

5. Alternative: Conversion Upon Attainment of Financial Performance Goals

The Series A Preferred shall be automatically converted into Common, at the then applicable conversion rate, (i) upon the closing of a firmly underwritten public offering of shares of Common of the Company at a per share price not less than $*[dollar amount]* per share and for a total offering of not less than $*[dollar amount]* (after deduction of underwriter commissions and expenses), or (ii) as of the end of any fiscal year of the Company in which the Company's audited financial statements for such year report at least $*[dollar amount]* in consolidated revenues and pretax profit (before extraordinary items) of at least *[amount of percentage]*% of consolidated revenues for the same period. All accrued but unpaid dividends on the Series A Preferred must be paid at the time of automatic conversion, either in cash or shares of Common valued at the then effective conversion price.

6. Anti-dilution Provisions

Proportional anti-dilution protection for stock splits, stock dividends, etc. In the event that the Company issues additional shares of Common or Common equivalents (other than *[number of shares]* shares reserved for issuance to officers, employees or directors of the Company pursuant to stock option or stock purchase plans and reserved for issuance upon exercise of outstanding warrants and for issuance for services and to the Company's Advisory Board) at a purchase price less than the applicable conversion price, an investor's conversion price shall be subject to adjustment based on a standard form of anti-dilution formula.

7. Mandatory Redemption

Beginning on the date that is *[number of years]* years following the Closing, the Company shall commence the redemption of the outstanding Series A Preferred on an equal quarterly basis over *[number of years]* years by payment of an amount per share equal to $*[dollar amount]* plus all accrued but unpaid dividends.

7A. Option: Company's Option to Redeem

On the date that is *[number of years]* years following the Closing, the Company will have the option to redeem all of the outstanding Series A Preferred by payment of an amount per share equal to *[amount of percentage]*% of the original purchase price of the Series A Preferred (i.e., $*[dollar amount]*) plus all accrued but unpaid dividends.

8. Voting Rights

Each share of Series A Preferred will carry a number of votes equal to the number of shares of Common then issuable upon its conversion. The Series A Preferred will vote together with Common and not as a separate class except as specifically provided herein or as otherwise required by law.

9. Protective Provisions

Consent of the holders of at least *[amount of percentage]*% of the Series A Preferred shall be required for any action which (i) alters or changes the rights, preferences or privileges of the Series A Preferred, (ii) increases or decreases the authorized number of shares of Preferred Stock or Series A Preferred, (iii) creates (by reclassification or otherwise) any new class or series of shares having rights, preferences or privileges senior to or on a parity with the Series A Preferred, (iv) results in the payment of any dividends on, or the redemption of, any shares of Common (other than pursuant to employee agreements), (v) results in any merger or consolidation, or any transaction in which all or substantially all of the assets of the Company are sold, or (vi) amends or waives any provision of the Articles relative to the Series A Preferred.

B. Information Rights

So long as an investor continues to hold shares of Series A Preferred or Common issued upon conversion of the Series A Preferred, the Company shall deliver to the investor audited annual (within 120 days of the end of the fiscal year and including a comparison to the Company's annual operating plan) and unaudited quarterly (within *[number of days]* days of the end of the fiscal year) financial statements.

So long as an investor (together with its affiliates) holds not less than *[number of shares]* shares of Series A Preferred or shares of the Common issued upon conversion of the Series A Preferred, the Company will furnish the investor with: (i) monthly financial statements within *[number of days]* days of the end of the month, (ii) a copy of the Company's annual operating plan within *[number of days]* days *[prior to/after]* the beginning of the fiscal year, and (iii) all updates to the annual plan when approved by the board. Each investor shall also be entitled to standard inspection and visitation rights. Other than with respect to the delivery of audited annual and unaudited quarterly financial statements, these provisions shall terminate upon a registered public offering of the Company's Common.

C. Registration Rights

1. Demand Rights

If investors holding at least *[amount of percentage]*% of the Series A Preferred and Common Stock issued on conversion ("Registrable Securities") request that the Company file a Registration Statement for at least *[amount of percentage]*% of the Registrable Securities (or any lesser percentage if the aggregate offering price to the public would be not less than $*[dollar amount]*, the Company will use its best efforts to cause such shares to be registered; provided, however, that the Company shall not be obligated to effect any such registration prior to one year from the date of Closing.

The Company shall not be obligated to effect more than *[number]* registration(s) under these demand right provisions, and shall not be obligated to effect a registration (i) during the *[number of days]*-day period commencing with the date of the Company's initial public offering, or (ii) if it delivers notice to the holders of the Registrable Securities within *[number of days]* days of any registration request of its intent to initiate such initial public offering within *[number of days]* days.

2. Company Registration

The investors shall be entitled to "piggyback" registration rights on all registrations of the Company or on any demand registrations of any other investor subject to the right, however, of the underwriters to reduce the number of shares proposed to be registered pro rata based on the number of Registrable Securities owned by such investors in view of market conditions. No shareholder of the Company shall be granted piggyback registration rights relative to the demand and piggyback rights contained herein which would reduce the number of shares includable by the holders of the Registrable Securities in such registration without the consent of the holders of *[amount of percentage]*% of the Registrable Securities. In the event of any reduction in the numbers of shares to be included in any registration, no Registrable Securities shall be excluded until all shares of Common held by persons other than the investors have been excluded from such registration.

3. S-3 Rights

Investors shall be entitled to *[number]* demand registrations on Form S-3 per year (if available to the Company) so long as such registered offerings are not less than $*[dollar amount]*.

4. Expenses

The Company shall bear registration expenses (exclusive of underwriting discounts and commissions) of all such demands, piggy-backs, and S-3 registrations (including the expense of one special counsel of the selling shareholders).

5. Transfer of Rights

The registration rights may be transferred provided the Company is given written notice thereof.

6. Standoff Provision

No investor holding more than *[amount of percentage]*% of the Company will sell shares within *[number of days]* days of the effective date of the Company's initial public offering if all officers, directors, and other *[amount of percentage]*% shareholders are similarly bound.

7. Future Registration Rights

The Company shall not grant superior registration rights to any future investors without the prior consent of the holders of at least *[amount of percentage]*% of the Registrable Securities.

8. Other Provisions

Other provisions shall be contained in the Purchase Agreement with respect to registration rights as are reasonable, including cross-indemnification, the period of time in which the Registration Statement shall be kept effective, and underwriting arrangements.

D. Right of First Refusal

Each investor shall have a right of first refusal to purchase its pro rata share of offerings of new securities of the Company other than securities issued to employees, directors or consultants or pursuant to acquisitions, etc.

E. Board of Directors

The Board of Directors shall consist of *[number of members]* members. Holders of the Series A Preferred will have the right to designate *[number of members]* members of the Board of Directors, consisting of one designee of each of *[names]*. The holders of Common shall have the right to designate *[number of members]* members of the Board of Directors. The remaining *[number of members]* members of the Board of Directors shall be elected by the holders of both of the Common and Series A Preferred, each voting as a separate class. The holders of the Series A Preferred will have the right to designate a majority of the members of the Board of Directors should the Company fail to redeem shares of, or pay the required dividends on, the Series A Preferred. The foregoing will be implemented in part through a Voting Agreement to be entered into between the investors, the persons listed on Exhibit *[designation of exhibit]* attached hereto and all holders of Common issued in the future.

[name of firm] will be entitled to designate an observer to attend each of the Company’s Board of Directors meetings.

All non-employee directors will be reimbursed for their reasonable out-of-pocket expenses incurred in connection with their service as a director.

F. Key Man Insurance

The Company shall keep in effect a $*[dollar amount]* key man insurance policy on the lives of each of *[names]*.

G. Purchase Agreement

The investment shall be made pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein, and appropriate conditions of closing, including an opinion of counsel for the Company. The Stock Purchase Agreement shall provide that it may only be amended and any waivers thereunder shall only be made with the approval of the holders of *[amount of percentage]*% of the Series A Preferred (or Common issued upon conversion thereof or some combination of such Common and Series A Preferred, but excluding shares previously sold to the public). Registration rights provisions may be amended or waived solely with the consent of the holders of *[amount of percentage]*% of the Registrable Securities.

III. Employee Matters

A. Employee Pool

Prior to the closing of this financing, there are *[number of shares]* shares reserved for issuance to employees. After the closing, such reserve will be increased to *[number of shares]* shares.

B. Founder Vesting

All stock held by each of the persons listed on Exhibit *[designation of exhibit]* attached hereto shall vest on a *[description of vesting schedule]* basis over *[number of years]* years with such *[number of years]*-year period being deemed to have begun on *[date]*. If either person voluntarily or involuntarily terminates his employment, the Company retains the option to repurchase unvested shares at a price per share equal to the lesser of $*[dollar amount]* or the then fair market value of the shares as determined in good faith by the Board of Directors.

C. Employee Vesting

All stock for other employees will be issued pursuant to stock options which would become exercisable annually in equal installments of *[amount of percentage]*% over *[number of years]* years. The Purchase Agreement will contain a covenant with respect to the foregoing vesting schedule.

D. Restrictions on Sales

Sales of stock by each of *[names]* (i) may not be made within *[months/years]* of the Closing, and (ii) may not exceed *[amount of percentage]*% of their holdings per year thereafter.

E. Right of First Refusal

The Company (or its assignee) will have a contractual right of first refusal on all transfers of Common by persons (other than the investors) who are referred to above as parties to the Voting Agreement.

F. Proprietary Information and Inventions Agreement

Each officer and employee of the Company shall have entered into an acceptable proprietary information and assignment of inventions agreement.

G. Non-Competition Agreement

[names] will enter into non-competition agreements with the Company that will provide that they will not compete in any manner, directly or indirectly, with the Company for a period of *[number of years]* year(s) following the termination of their employment with the Company.

IV. Other Matters

A. Conditions Precedent to Financing

1. Completion of legal documentation satisfactory to the prospective investors.

2. Satisfactory completion of due diligence by the prospective investors.

3. Review of employee stock purchase arrangements and, if necessary, modifications or amendments thereto.

It is anticipated that the transaction will close on or before *[date]*, but in no event later than *[number of days]* days after *[date]*.

B. Finders

The Company shall indemnify the investors for any finder's fees for which the Company is responsible relating to this transaction.

C. Legal Fees and Expenses

The Company shall pay the reasonable fees and expenses of *[name of firm]*, special counsel to the investors.

D. Option: Co-Sale and Right of First Refusal Agreement

Subject to the Company's right of first refusal described above, each holder of the Series A Preferred (or the underlying shares of Common) will have (i) a right of co-sale with respect to future sales of equity securities by. persons (other than the investors) who are referred to above as parties to the Voting Agreement, subject to customary carve-outs for estate planning purposes or for sales of de-minimus amounts of stock for emergency purposes, and (ii) a right of first refusal with respect to sales of the equity securities of such parties.

E. Option: Marketing Agreement

The Company shall agree to make *[name of firm]* a good faith "first offer" to negotiate a marketing agreement for any products that the Company wishes to sell through a third party. *[name of firm]* will have *[number of days]* days to respond and if the response is negative and a marketing agreement with more favorable terms was then negotiated with a third party, *[name of firm]* would be given the right to accept or refuse the new agreement with similar *[ordinal number of day]* response requirements. This right shall expire on *[date]* and shall not be transferable by *[name of firm]*.

F. Option: Drag-Along Rights

Holders of the Series A Preferred (or the underlying shares of Common), each of the persons listed on Exhibit *[designation of exhibit]* attached hereto, and all future holders of greater than *[amount of percentage]*% of the Common (collectively, the "Major Shareholders") shall agree that if, beginning on the date that is *[duration]* after the date of the initial sale of the Series A Preferred and prior to an initial public offering of the Common, one or more Major Shareholders owning, individually or in the aggregate, at least *[amount of percentage]*% of the Common (assuming conversion of all convertible securities of the Company and exercise of all outstanding options to purchase equity securities of the Company), whether alone or in concert with any other Major Shareholder, propose to sell to any person or group who are not affiliated with any of such Major Shareholder(s) (collectively, an "Offeror"), in a bona fide arm's-length transaction or series of transactions (including by way of a purchase agreement, tender offer, merger or other business combination transaction or otherwise), all of the equity securities of the Company held by such Major Shareholder(s) (any such transaction being referred to herein as an "Exit Sale"), then the selling Major Shareholders may elect to require all other Major Shareholders to sell all the equity securities of the Company owned by each of them concurrently with such Exit Sale to such Offeror at the same purchase price.

G. Option: No Shop

(a) The Company and the Founders agree to work in good faith expeditiously towards a closing. Subject to the provisos below, the Company and the Founders agree that they will not, for a period of *[duration]* from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance of any of the capital stock of the Company and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing; provided, however, that the obligations of the Company and the Founders described in this sub-section (a) shall (i) be conditioned upon the Investors diligently proceeding in good faith in their due diligence investigation and toward the execution of mutually acceptable definitive agreements regarding the sale and purchase of the Series A Preferred and the other matters described herein and (ii) not apply in the event that counsel to the Company advises the Investors that compliance with the foregoing would constitute a breach of the fiduciary duties of the Company's Board of Directors.

(b) In the event that the Company breaches this no-shop obligation and, prior to *[date]*, closes any sale or issuance of any of the capital stock of the Company without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction, then the Company shall pay to the Investors $*[dollar amount]* upon the closing of any such transaction as liquidated damages.

H. Option: Confidentiality

The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to *[name of lead investor]*, as lead Investor, without the written consent of the Investors.

Notes

This form is an example of a summary of terms, or "term sheet," used in connection with a Series A Preferred Stock financing with the capital be raised principally from venture capitalists. Negotiation of a term sheet is an excellent opportunity for the parties to hammer out their relationship, particularly the delicate issues relating to participation of the investors in the management of the company and the terms of any employee agreements and restrictions on transfer of the founders' shares.

This form assumes that the company is issuing its first series of preferred shares and that the core group of employees is limited to several founders. Further commentaries on the issues raised herein can be found in some of the definitive agreements that must be drafted to implement the provisions in the term sheet. These include an investment agreement (§ 156:164) articles of incorporation (§ 156:271), and a stock transfer and restriction agreement (§ 156:303). Other examples of term sheets can be found as Specialty Form at § 156:361, Specialty Form at § 156:362, Specialty Form at § 156:360, Specialty Form at § 156:363, and Specialty Form at § 156:364.

I Offering

The first section of the term sheet provides a description of the general terms of the offering, including the effect that the offering will have on the existing capital structure of the company. Certain items covered in this section, particularly the number and type of shares (§ 156:113), price per share (§ 156:114) and the pre-financing valuation (§ 156:115), are important points of negotiation between the investors and the members of the founding and management group.

A Issuer

This paragraph should set out the full legal name of the company. In some cases, the information should include the corporation's state of incorporation. If a reorganization is contemplated prior to the closing of the financing, such as incorporation of a limited liability company, this should be described in the term sheet.

B Amount of Financing

This section sets out the range of the amount of funds that the company is looking to raise in the offering. While the company usually has a fixed target amount for its capital raising efforts, it will often accept additional funds (and the attendant dilution) in certain circumstances, such as when the funds are being provided by a strong investor that may be able to provide support and contacts with other business partners.

C Type of Security

As noted in the summary, this term sheet pertains to an offering of convertible preferred stock. Since this is the initial series of preferred shares, it is referred to as "Series A."

D Price

The price per share is obviously an important consideration. Among other things, it determines the liquidation preference for the Series A Preferred Stock. In addition, the price per share for the preferred serves as a reference point for determining the offering price for common shares which may be sold to employees for compensation purposes following the sale of shares to investors.

E Pre-Financing Valuation

This section sets out the pre-financing capitalization of the company, including all the shares which are reserved for future issuance to employees, consultants, and others. By multiplying the "fully-diluted" share number by the proposed purchase price, one can determine the pre-financing valuation of the business.

F Use of Funds

This section should include a brief description of the intended use of proceeds. Obviously, the investors will be provided with a detailed summary of the company capital spending strategy as part of the due diligence process and in the company's private placement memorandum. Since the investors will generally have the right to elect one or more representatives to the board of directors, they will have an opportunity to monitor the way in which the funds are used.

G Purchasers

In many cases, the identify of all of the members of the investor group will be unknown at the time that the term sheet is prepared. However, if one or more major investors have committed to "take the lead," they should be identified in the term sheet to verify that they have signed on to the proposed terms of the transaction. The list of purchasers also provides an opportunity for the members of the investor group to sort out how the total capital commitment will be divided.

II Terms of Series A Preferred Stock

This section sets out the key terms upon which the investors will be providing their funding. It not only includes the rights, preferences, privileges and restrictions of the Series A Preferred Stock ([§§ 156:118 to 156:133, Rights, Preferences, Privileges and Restrictions]), but also various covenants and agreements with the investors regarding such important items as:

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- • information rights (§ 156:134);
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- • registration rights; ([§§ 156:135 to 156:142, Registration Rights]); and
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- • management participation (§ 156:144).

A Rights, Preferences, Privileges and Restrictions

This section describes the essential rights and preferences of the Series A Preferred Stock as would be set out in the company's charter documents. Key issues include the following:

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- • Dividends (§ 156:118);
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- • Liquidation preference (§ 156:121);
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- • Conversion rights and obligations (§ 156:126) (including anti-dilution provisions (§ 156:129);
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- • Redemption (§ 156:130); and
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- • Voting rights (§ 156:132) (including protective provisions (§ 156:133).)

To learn more about the rights, preferences, and privileges of preferred shares, see Master Form at § 156:271.

1. Dividend Provisions

The preferred shares will have a preferred right to receive dividends prior to the payment of dividends to the holders of the common shares of the company. This preference will typically be expressed by a provision which restricts the ability of the company to make dividend payments on its common shares for any period until the holders of the preferred shares have received dividends equal to the amount owed to such holders for that period, as well as any additional accumulated dividends from prior periods.

The main provision in this form calls for dividends to be "non-cumulative." Possible alternatives include:

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• Non-cumulative dividends switching to cumulative (§ 156:119), which may be used in cases where the investors want to protect against the possibility that the company will fail to hit its developmental milestones; or

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• Cumulative dividends (§ 156:120), which are often used in cases where all or most of the money is being supplied by institutional investors.

When a non-cumulative dividend provision is used, there is no absolute commitment on behalf of the company to make any dividend payments to the holders of the preferred shares. Instead, holders of preferred shares will only be entitled to receive dividends if, when and as declared by the board of directors. Accordingly, even if there are funds legally available to make a dividend payment, if the board decides not to make a distribution and retains the funds for use in the business, the dividend is lost to the holders of the preferred shares. One common variation of a non-cumulative dividend provision is to specify that dividends need only be paid for those periods in which the company has funds legally available to make the payment.

In some cases, the investors may bargain for the right to participate in dividends paid on the common shares if holders of the preferred shares would have been entitled to receive a larger amount of any dividend distribution if they had converted their shares of preferred shares into common shares prior to the distribution.

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• For example, if a dividend of $0.15 per share is declared on the common shares, and the preferred shares are convertible into one common share and has a non-cumulative dividend preference of $0.10 per share, the participation provision would entitle the holders of the preferred shares to a distribution of $0.15 per share (i.e., the $0.10 per share with respect to the preferred shares and the additional $0.05 per share which would have been payable to such holders if they converted their preferred shares into common shares).

1. Alternative 1: Non-Cumulative Dividends Switching to Cumulative

Sometimes dividend provisions may be non-cumulative at the time the preferred shares are originally issued, but will become cumulative after some date in the future, which date is usually set by reference to certain financial and operational milestones.

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• If the parties mutually agree that it is reasonable to expect that the company will be in a position to complete a public offering of its common shares within a certain period (e.g., four years from the date of the financing), the investors may agree that dividends will not begin to accumulate until the anticipated IPO date has passed.

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• Other common milestones might include the closing of an additional round of financing by the company or attainment of a specified level of revenues or sales.

1. Alternative 2: Cumulative Dividends

In contrast to non-cumulative dividends, a provision which calls for cumulative dividends creates a continuing obligation on the company to pay the amount of any dividends which, for whatever reason, are not paid in the current period.

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• Cumulative dividends may continue to accrue until the company has funds available which can legally be used to make the dividend payments.

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• Alternatively, payment of cumulative dividends can be deferred until the board of directors makes a determination to declare payment, thereby giving the board some flexibility to retain earnings in the company rather than to use them to pay dividends from prior periods.

The amount of any accumulated dividends is generally added to the amount that must be paid to the holders of the preferred shares upon liquidation of the corporation or redemption of the preferred shares, although in some cases accumulated dividends payable at the time of liquidation are subordinated to the payment of liquidation preferences on any series of preferred shares that is not entitled to cumulative dividends.

When cumulative dividend provisions are utilized, investors may insist upon a variety of restrictions on certain payments or distributions by the company that might jeopardize the ability of the company to make future dividend payments to the holders of the preferred shares. Obviously, as noted above, no dividends will be permitted on the common shares so long as their are any accumulated dividends on the preferred shares. In addition, even in those cases where the company is current on its dividend obligations, payment of dividends on the common shares may be prohibited unless, after the payment, the company still maintains a minimum:

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• Current asset ratio;

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• Level of retained earnings; or

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• Ratio of tangible net worth to liquidation preference.

Some investors will prohibit any distributions with respect to common shares, other than payments made to repurchase shares owned by employees who no longer are employed by the company.

2. Liquidation Preference

One of the basic features of preferred shares is the priority claim that holders thereof will have over holders of common shares with respect to distributions made upon liquidation of the company. For many years, the holders of preferred shares were entitled to receive a fixed amount, generally the original purchase price of the shares plus the amount of any accrued but unpaid dividends on the preferred shares, upon liquidation before any distributions were made to the holders of the common shares. The holders of the common shares were entitled to the entire amount of any remaining residual value of the company following satisfaction of the preferred shares liquidation preference.

However, if the residual value was great enough, the investors could waive their liquidation preference by converting their preferred shares into common shares and sharing the value with the other holders of common shares on a pro rata basis. This provision is illustrated by the language included in the main text of this form.

The traditional liquidation preference formula protected the investors in those cases where the company's liquidation value was no more than the amounts paid in by the investors. In those cases where the company had appreciated in value, holders of the common shares were allowed to "catch up" with the holders of the preferred shares after the initial preference was paid; however, since holders of common shares generally had paid much less for their shares, they often were able to achieve significant returns on their investment while the investors received nothing more than the return of the money which they had invested some years earlier.

As more and more investors began to discover that a number of their companies were achieving liquidation values that exceeded their investment, yet were not high enough to justify conversion into common shares, they began to bargain for the right to participate in these gains along with the holders of common shares.

Participating liquidation preferences allow the holders of preferred shares to receive not only their liquidation preference, but also any additional amount they would have been entitled to receive if they had elected to convert their preferred shares into common shares. While there are several different methods which may be used in designing a participation feature, the effect of such a provision is to substantially dilute the economic interest of the common shareholders. As such, the founders and any other major holders of common shares will sometimes strongly resist the use of such a provision. However, the final resolution generally depends upon the overall attractiveness of the investment and the beliefs of each of the parties as to the most probable exit mechanism for their investments in the company.

The most extreme form of participating preferred shares will allow the investors to retain the preferential right to receive the amount of their investment and to participate fully in any residual value which may remain after their preference has been satisfied. See Alternative 1 § 156:122. Since a full participation formula effectively ignores the fact that the holders of the common shares have also paid some amount for their shares, one common variation calls for payments of a fixed amount to all the holders of common shares before the holders of the preferred shares begin to participate; however, as the holders of the common shares will generally have paid different amounts for their shares, this formula may not fully compensate all the common shares holders. See Alternative 3 § 156:124.

Another alternative would allow the investors only to participate up to a specified return level, such as the amount of the initial public offering price which would have triggered an automatic conversion of the preferred shares. See Alternative 2 § 156:123.

2. Alternative 1: Participating Preferred

This provision provides the greatest economic benefit to the investors since it not only allows them to retain their liquidation preference, but also to participate "as if" they elected to forego the preference and convert their shares to common stock. Some investors will only invest on this basis, and a full participating preferred can be particularly valuable when the liquidation preference is to be applied in determining entitlements upon a merger or sale of the company.

2. Alternative 2: Participating Preferred with Cap

This formulation is a bit of a compromise between the traditional "non-participating" scheme and full participation for the investors. The effect of the provision is to provide investors with an additional return, based on the amount invested and the time that has passed since the investment was made, before turning the remaining amount over to the common shareholders. The "rate of return" is a matter for negotiation; however, it generally falls between the dividend rate and the preferred rate of return that the investors would have hoped to receive if the investment succeeds. Thus, a percentage of 15%–18% would be a useful starting point. Of course, investors always have the opportunity to convert their shares into common if the value of the company has risen substantially such that the residual interest is more valuable than the preference.

2. Alternative 3: Participating Preferred with Minimum Payment on Common

While it would appear that the fairest participation method would provide for each holder of common shares to be paid the actual amount which he or she paid for their shares before the preferred shares begins to participate, few companies are willing to take on the burden of creating the multiple classes or series of the common shares which might be required in order to achieve such a result. As a result, a single price is fixed for payment to all the holders of the common shares. The price usually corresponds to one of the following measures:

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- The price per share paid by the members of the founding group;
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- The fair market value of the common shares as of the time that the last series of preferred shares was issued; or
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- An arbitrary price chosen to provide a specified rate of return to most of the holders of the common shares, assuming that the liquidating event results in a company valuation that would trigger the participation rights of the investors.

3. Merger, Consolidation

In many cases, the articles of incorporation will provide that mergers and similar transactions will be deemed a liquidation under the terms of the preferred shares, thereby ensuring that preferred shareholders will at least have the right to receive their original investment back upon the occurrence of such a transaction. This type of provision can be particularly important to the investors in those situations where the liquidity for their investment comes not from a public offering, but rather from a negotiated sale of the business to a third party.

Some preferred shares provisions are either silent as to the rights that the holders of preferred shares are to have with respect to any payments made upon the occurrence of a merger or acquisition or simply include a requirement that the company may not consummate any such transaction without the consent of a specified percentage-in-interest of the holders of the preferred shares, unless provision is made for such holders to receive the same amount that they would have received if the transaction were deemed to be a liquidation.

Another alternative provision would give the holders of preferred shares a right to maintain their "preferred" position following the completion of the transaction, as well as the right to convert any preferred securities received in the transaction into the number of shares, securities or property which the holder would have received had the holder simply converted the preferred shares into common shares at the time of the transaction.

4. Conversion

By definition, convertible preferred shares are convertible into common shares of the company upon satisfaction of certain conditions. In this case, the preferred shares can be converted at any time following issuance; however, as a practical matter, the investors will not forfeit their "downside" protections until the company has achieved financial success of such magnitude that the investors are compelled to convert under the automatic conversion provisions (§ 156:127) described below.

The conversion ratio, which is the number of common shares which will be issued upon conversion of the preferred shares, is original price for the preferred shares divided by the conversion price at the time. Typically, the initial conversion ratio for the preferred shares is established at one share of common stock for each share of preferred stock to be converted. However, the conversion ratio will be subject to adjustment over time to account for future dilutive events, such as issuances of new securities at a per share purchase price lower than the preferred shares purchase price. See 6 (§ 156:129).

The parties contemplate that the company would have the right to force conversion of all of the preferred shares if a majority-in-interest of the holders of the preferred shares has elected to convert on their own. In some situations, when the company's prospects have taken a turn for the worst and new financing can only be obtained at a much lower valuation than when prior financings occurred, it will become necessary for the existing preferred shareholders to give up their preferences and convert their shares into common shares in order to induce new investors to participate. The ability of a majority of the holders of the preferred shares to force conversion of all of the shares of preferred shares facilitates this type of transaction, sometimes referred to as a "cram-down" financing, in which the new investors receive preferred shares and the old investors have their shares converted into common shares, which generally have a value equal to only a fraction of their original purchase price.

Allowing a majority, but less than all, of the holders of the preferred shares to effect a conversion of all of the preferred shares provides a means for ensuring that a small number of preferred shares holders are not able to continue to use the special voting rights granted to the class to disrupt the affairs of the corporation.

5. Automatic Conversion

Automatic conversion of the preferred shares is usually required upon the closing of a firmly underwritten public offering of the company's common shares at a per share price and for an aggregate offering price in excess of stipulated levels. The per share price generally depends upon the timing of the investment and may be set at anywhere from three to five times the common shares equivalent price paid by the investor.

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• The aggregate offering price condition is intended to ensure that the public market for the common shares (i.e., the "float") is large enough to provide liquidity for the shares of common shares received by the investors upon conversion.

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• As a general rule, the underwriters will insist that the preferred shares be converted into common shares in order to enhance the marketability of the offering, whether or not the automatic conversion criteria have been satisfied.

In the first round of financing, the automatic conversion price is generally set at the higher end of the range of multiples which are typically used (i.e., four to five times the purchase price). In later rounds of financing, the multiple will decline, sometimes to as low as two times the purchase price, reflecting the growth and maturity of the company and the fact the later round investors may not have to wait as long as earlier investors for a public offering in order to liquidate their investment. The size of the offering required for automatic conversion is generally set by reference to the aggregate proceeds received by the company, rather than the total amount of the underwriting, which may include secondary shares.

While creation of a public market for the common shares is the most common automatic conversion event, some companies successfully argue for other automatic conversion events, such as attainment of financial performance goals, which might occur before the company actually goes public. See Alternative (§ 156:128).

5. Alternative: Conversion Upon Attainment of Financial Performance Goals

In this case, automatic conversion upon completion of a public offering has been supplemented by a requirement that the preferred shares be converted once the company has achieved certain revenue and profitability standards. Another alternative trigger for automatic conversion is the closing of a private placement financing transaction in excess of a certain minimum dollar amount.

6. Anti-dilution Provisions

The conversion ratio (§ 156:126) for the preferred shares is always adjusted for shares splits, shares dividends and consolidations in order to insure that the economic interests of the holders of the preferred shares remain unchanged following such events. However, more importantly, preferred shares provisions often include some type of anti-dilution mechanism which applies to the issuance of common shares or common shares equivalents at prices lower than the common shares equivalent price paid by the investors. These anti-dilution provisions make downward adjustments in the conversion price of the preferred shares, which is originally established as the price per share paid for the preferred shares. Accordingly, a downward adjustment in the conversion price will increase the number of shares issuable upon conversion.

The most common anti-dilution provision, referred to in this form, uses a "weighted average" formula that adjusts the conversion price based upon the number of shares outstanding before and after the new issuance and the price per share paid for the new securities.

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• For example, one widely used weighted average anti-dilution formula determines the new conversion price by multiplying the old conversion price by a fraction the numerator of which is the sum of (i) the total number of fully-diluted shares of common shares outstanding prior to the offering plus (ii) the number of shares of common shares which would have been issued had the purchase price for the new shares been equal to the old conversion price, and the denominator of which is the number of shares of common shares that are actually being issued in the new financing.

This formula treats all of the common shares that are outstanding or deemed to be outstanding prior to the new financing as having been issued at a price equal to the conversion price then in effect and lowers the conversion price to an amount which reflects the weighted average of this deemed purchase price of the previously outstanding shares and the actual purchase price of the newly issued shares.

Another commonly used weighted average anti-dilution formula attempts to take into account the amount raised in the new dilutive financing in relation to the "deemed" value of the company prior to the financing.

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• Under this formula, the new conversion price would be determined first by multiplying the total number of outstanding shares of common shares prior to the new issue by the old conversion price and then adding that result to the total consideration which they company would be receiving in the new financing. This amount would then be divided by the total number of outstanding shares of common shares after the financing assuming, of course, conversion of all prior series of preferred shares at their old conversion ratios. Depending on the circumstances, this formula will lead to a result which differs from that achieved using the "share-based" formula described above.

A somewhat drastic alternative to the "weighted average" provisions is "ratchet-down" anti-dilution provisions which simply reduce the conversion price to the most recent lower price that new common shares equivalents were issued, regardless of how many shares were issued and the relation thereof to the outstanding capital shares of the corporation. "Ratchet-down" provisions are often used in conjunction with some form of "weighted average" formula.

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• For example, “ratchet” adjustments may be limited to the first financing following the issuance of the preferred shares to which the formula applies, or only to financings, regardless of the number, which occur during a specified period of time after the original issuance. Thereafter, any additional adjustments to the conversion price would be computed under the “weighted average” formula.

As a general rule, anti-dilution provisions continue to benefit the holders of a particular series long after they have made their investment in the company, even if they have ceased to be an active participant or failed to provide further financing. Some venture capitalists believe that investors should not be able to get the benefits of anti-dilution provisions unless the investor is willing to assist the company in remedying its difficulties by actually participating in the dilutive financing.

In such cases, so-called “pay to play” anti-dilution provisions will be utilized, which provide that the investors will have the right to participate in their “pro rata” share of any dilutive financing and, if they fail to participate, their shares will be automatically converted upon closing of the financing into shares of a “derivative” series of preferred shares. This derivative series, typically denominated in a manner which links it to the original series (e.g., Series A for the original series and Series A-1 for the derivative series), will be identical to the original series but for the fact that it no longer has a provision for adjustment of the conversion price for dilutive issues.

The rights, preferences and privileges of the derivative series, as well as the investors’ rights to participate “pro rata” in any future dilutive financing, must generally be set out in the articles of incorporation prior to the dilutive financing in order to be effective.

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• If some of the investors participate in the first dilutive financing, thereby gaining the benefits of the reduction in the conversion price under the anti-dilution formula, then it is necessary to create a second derivative series (e.g., Series A-2) into which shares held by investors who participate in the first, but not the second, dilutive financing would be converted.

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• Shares of this second derivative series would be convertible at the price which applied after the first dilutive financing, but holders would not be entitled to any further price anti-dilution provisions.

In extreme cases, “pay to play” provisions can greatly complicate the drafting of the articles of incorporation.

Some anti-dilution provisions call for adjustments to the conversion price if the common shares equivalent price of the new issue is less than the then current “market price” for the common shares.

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• These “market price” anti-dilution provisions are of little value in venture capital transactions, since no trading market exists for the company’s common shares.

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• However, “market price” provisions may be used by the company after it has gone public and decides to sell warrants or convertible equity or debt securities.

It is the rare case where all new issuances of securities trigger the application of the anti-dilution provisions. Common exceptions to adjustments in conversion price and anti-dilution provisions include:

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• The issuance of shares of common shares upon conversion of any of the previously outstanding shares of preferred stock;

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• The issuance of a fixed number of shares to employees and consultants of the company and its subsidiaries under a share purchase and option plan for the purpose of recruiting, maintaining and compensating the human resources necessary for the business to flourish.

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• Securities issued to suppliers, distributors, customers and lenders; and

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• Securities issued in connection with acquisitions.

The board of directors may be given the power to waive the effect of the anti-dilution provisions in certain instances, although this is usually only permitted when the investors control the board.

7. Mandatory Redemption

Some investors, as well as some companies, will bargain for various provisions relating to the redemption (i.e., repurchase) of the preferred shares in certain situations. There are two general categories of redemption provisions:

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• Optional redemption (§ 156:131), which gives the company the right to redeem the preferred shares at a price equal to the original issuance price of the shares plus a redemption premium; and

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• Mandatory redemption, which imposes an absolute obligation on the company to redeem the preferred shares at the times and on the terms specified in the articles of incorporation.

In addition, the investors may be given the right to compel the company to redeem the shares at the option of the investors. This right, in effect, is a "put," and actually is little different from a mandatory redemption provision coupled with a right of the investors to waive or defer redemption.

As a general rule, the redemption price to be paid upon any repurchase of shares will be equal to the original issue price of the shares plus any accumulated dividends. However, in the case where redemption can occur at the option of the company, the basic price may be supplemented by an additional amount, referred to as a "call premium," which is intended to compensate the investors for relinquishing their senior position, either through redemption or by a forced conversion of their preferred shares into common shares.

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• For example, the redemption provisions may provide that the company would have the right to redeem the preferred shares at a price that is equal to 110% of the basic redemption price if the option is to be exercised within a certain period. The amount of the premium is usually reduced over time, so that after a certain period of years (e.g., five to seven) the redemption price once again equals the original issue price plus any accumulated dividends.

While a call premium may be an attractive feature for investors, such a provision may result in adverse tax consequences.

The main provision in this form calls for mandatory redemption. Mandatory redemption provisions generally call for the repurchase of the preferred shares in installments commencing on a date in the future (e.g., five years). Redemption payments are generally made on an annual basis over a specified period (e.g., three or four years). However, the parties may agree on some other payment schedule, including quarterly payments.

The obligation to redeem the preferred shares is always subject to the availability of a sufficient amount of funds to legally complete the redemption.

- • If funds are not available, the obligation either carries over to the next scheduled redemption date or is made payable over all of the remaining installments.
- • In some cases, the company is required to establish a “sinking fund” into which funds are deposited prior to the scheduled redemption date(s) to secure the performance of the company’s obligations on the redemption date(s).

Both companies and investors will approach any sort of mandatory redemption provisions with some reluctance.

- • From the company’s perspective, mandatory redemption provisions may have an adverse effect upon the company’s ability to raise funds in future financings if new investors believe that the financing proceeds will simply be used to redeem the shares held by the old investors rather than for operation of the business.
- • In turn, the investors will be concerned about the possible effect of mandatory redemption provisions in those cases where the value of the company’s shares on the redemption date exceeds the redemption price, but the future value of the shares is so uncertain that investors are reluctant to give up the various protections provided by the preferred shares.

As a result, companies will prefer optional redemption provisions, while the investors will either bargain for a “put” right or for the ability to waive or defer a mandatory redemption payment.

7A. Option: Company’s Option to Redeem

Optional redemption provisions provide the company with a method for forcing the investor to convert the preferred shares into common shares if the investor wants to retain its interest in the growth of the company. By forcing conversion, the company is able to eliminate the special rights associated with the preferred shares with respect to dividends, liquidation and voting, and simplify its overall capital structure in anticipation of a public offering or a merger. Realizing the leverage that optional redemption rights can provide the company, investors are generally reluctant to agree to such provisions. On the other hand, the company may be able to obtain agreement on this issue if it is willing to agree to defer the exercisability of the option for a specified period of years.

Given the resistance that many investors will have to giving the company an option to redeem their shares, the parties may opt for reducing the hurdles which must be achieved in order for the preferred shares to automatically convert into common shares. This would give the company some comfort that the special privileges of the preferred shares can be terminated at some time in the future, while allowing the investors to retain their senior position until the company has actually fulfilled certain financial or operational goals and objectives.

8. Voting Rights

Convertible preferred shares typically vote along with the common shares on all matters and are entitled to one vote for each share of common stock into which the preferred shares are permitted to convert at the time of the vote. Also, in most cases, preferred shares will have the benefit of certain protective provisions (§ 156:133) which provide holders with a right to vote as a separate class on matters that materially impact their investment in the company.

9. Protective Provisions

Holders of the preferred shares will usually have the right to protect their position with the company through the use of separate class voting requirements on certain corporate transactions, including:

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• The issuance of new senior securities;

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• Mergers and acquisitions; and

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• Amendments to the rights, preferences and privileges of the preferred shares.

Protective provisions are designed to give the holders of the preferred shares a separate right to vote on and approve any of the matters specified in the terms of the preferred shares.

Voting requirements will depend upon the composition of the investor group and usually are set at a level which insures that no action will be approved unless the consent of most of the major investors is received. While the protective provisions may last for as long as any shares of preferred stock are outstanding, it is common to provide that the special voting rights will terminate if the total number of outstanding shares of preferred stock falls below a specified percentage (e.g., 25%) of the originally issued shares, thereby preventing a minority of the preferred shareholders from exercising a disproportionately large degree of control over the company.

B Information Rights

The company will almost always agree to provide the investor with certain financial and operating information, including annual and quarterly balance sheets and income statements prepared in accordance with generally accepted accounting principles applied on a consistent basis.

Major investors, defined by reference to the dollar amount of their investment (e.g., $500,000 or more), may be given supplemental rights to receive monthly reports of the following items:

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• Sales;

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• Production;

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• Shipments;

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• Profits;

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• Cash balances;

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• Receivables;

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• Payables;

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• Budgets;

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• Projections;

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• All statements filed with the SEC or other agencies;

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• Notification of significant lawsuits or other legal proceedings; and

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• Any other information that the investors need for voluntary or involuntary filing requirements.

In some cases, the financial statements must be accompanied by a certificate from the company's chief executive or financial officer and, in the case of audited financial statements, its auditors, to the effect that the company is in compliance with all provisions of the investment agreement.

Each investor will be asked to agree to keep confidential any proprietary or secret information that might be delivered to it by the company; however, in some cases, investors will only agree to the confidentiality provisions as to materials and information which the company actually marks "confidential." As a general rule, investors will be permitted to share materials with their counsel and accountants.

Generally, the rights to receive information regarding the company may be assigned in connection with any subsequent sale or transfer of the shares held by an investor assigning the rights, provided that the company may refuse to allow such assignment if it believes that the assignee is a competitor of the company. The rights to receive supplemental information provided to any major investors usually can only be assigned to assignees who purchase or otherwise receive that number of shares which have an original purchase price equal to the threshold for receiving the information in the first place.

In addition to the right to receive written information from the company, the company will generally agree to permit each investor, at the investor's expense and such reasonable times as may be requested by the investor, to:

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• Visit and inspect the company's properties;

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• Examine the company's books of account and records; and

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• Discuss the company's affairs, finances, and accounts with its officers.

The right to inspect books and records is particularly important in the case of debt financings, since the investor will generally be relying on the company's ability to make periodic payments of interest and principal. As with the general right to receive written information, investors will be required to treat secret information received during any visit or inspection as confidential.

C Registration Rights

The securities acquired by the investor in a private placement are deemed to be "restricted securities" which can only be sold in accordance with SEC Rules 144 or 144A, or as part of an offering in which the securities are actually registered under the Securities Act.

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• Rule 144 permits resales without registration if various conditions are satisfied, including minimum holding period requirements and the availability of certain information regarding the company.

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• Rule 144A can be used for resales to a limited group of potential purchasers, generally referred to in Rule 144A itself as "qualified institutional buyers."

Both Rule 144 and Rule 144A have a number of limitations from the perspective of the venture capital investor seeking future liquidity:

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• Rule 144 cannot be used for at least one year from the date of the original purchase and, even then, will only be available if the issuer prepares and distributes the type of information which a public company is obligated to file with the SEC.

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• If the securities have been held for more than two years from the date of the original purchase, and thus can be sold even if public company type information is not available, the investor may not be able to attain the desired level of liquidity unless a broad market exists for the securities (i.e., the company has "gone public").

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• Sales under Rule 144 are subject to certain limitations regarding the number of shares which can be sold under the Rule during a particular three-month period, thereby restricting the liquidity that major shareholders might be able to obtain under the Rule.

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• Rule 144A only facilitates resales to investors who are deemed to be qualified institutional buyers, a class of investors which, with certain exceptions, is limited to institutions that own and invest on a discretionary basis at least $100 million in securities of nonaffiliated institutions.

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• While holders of "convertible securities," such as convertible preferred shares, can "tack" their Rule 144 holding periods upon conversion, investors acquiring their securities through the exercise of warrants will generally not be able to use Rule 144 until one year has passed since the exercise of the warrants.

These limitations generally cause the investors in any private placement transaction to negotiate for "registration rights," which are contractual obligations imposed on the company to register the investor's securities for public resale under the Securities Act under certain circumstances. Registration rights facilitate the sale by the investors of more securities than they would normally be able to sell under Rule 144 and, in the extreme case, can actually be used to create a new public market for the securities even though company management might not otherwise be eager or willing to incur the expense of preparing a registration statement and the responsibilities and potential risks associated with being a public company.

Registration rights fall into two general categories:

1.

1. A demand registration right (§ 156:135) allows an investor to require that the company file a registration statement which covers the securities that the investor wishes to have resold into the public market.

2.

2. A piggyback registration right (§ 156:136) allows an investor to include securities in a registration statement that the company has already decided to file, including a registration statement filed due to exercise of a demand right by other shareholders.

1. Demand Rights

A demand registration right entitles a holder of any registrable securities, on demand, to require that the company prepare and file a registration statement covering the sale of the requesting holder's securities to the public. There are actually two types of demand registrations which are generally covered in the registration rights provided to investors.

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• The first type of demand registration covers registration statements filed on Form S-1, which requires full disclosure in the prospectus of all the material information regarding the company and the proposed distribution.

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• The second type of demand registration, which is considered to be much less onerous than the first type, refers to the registration of securities on Form S-3 (§ 156:137), which will only be available to the company after it has completed an offering on a Form S-1 registration statement.

Although demand rights for a registration on Form S-1 are rarely exercised, the existence of such rights gives the holder significant leverage in dealing with the company's management with respect to the nature and timing of registrations initiated by the company.

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• For that reason, investors usually insist upon demand registration rights and at least one demand registration right is commonly given to the investors in major rounds of venture capital financings.

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• On the other hand, companies are relatively liberal in permitting investors to request registrations on Form S-3 (§ 156:137) and Form S-3 registration rights are generally covered in a separate portion of the registration rights and not as part of the provisions which relate to Form S-1 registrations.

If the requisite percentage-in-interest of the holders wish to request the company to register their shares on Form S-1, they must deliver a written request to the company specifying the number of shares which such holders, commonly referred to as the "initiating holders," wish to have registered and whether the proposed offering is to be underwritten. Assuming that the company is obligated to effect a demand registration at the time that the request is made, it must then promptly give notice of the proposed registration and offering to all the other current holders of registrable securities. The other holders will have a specified period (e.g., 20 days from the receipt of the notice from the company) to elect to include shares in the proposed registration; provided, however, that if the shares are to be sold in an underwritten offering, such holders may not participate unless they agree to the terms of the arrangement with the underwriters for distribution of the shares.

The most important issue relating to demand registration rights is the question of when the rights first become exercisable. In some cases, the rights may not be exercised until after the company goes public on its own accord. In other situations, the rights will not become effective until the earlier of:

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• Some period of time (e.g., six months) after the company's initial public offering; or

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• A date which is some significant amount of time (e.g., three years) after the financing has been completed, thereby providing management with the flexibility to determine the optimum time to take the company public.

Another mechanism for controlling the exercise of demand rights is to allow the company to delay a registration for a fixed period of time (e.g., six months) if the board determines in good faith that to effect a registration in the near future would be seriously detrimental to the company or its shareholders. As a general rule, the investors are willing to agree to some reasonable delay before the demand rights become exercisable, since they realize the difficulties associated with completing a secondary offering, particularly if the company has not yet gone public or the company's management has reservations regarding the timing of the offering. This provision can be useful when immediate registration may be harmful to the company, or viewed adversely by the market, due to adverse business development or contemplated acquisitions.

Similarly, in order to insure that a demand registration does not have an adverse impact upon another pending offering of the company's securities, investors may be precluded from making a demand for a period which begins a certain number of days (e.g., sixty) before the estimated date for filing a registration statement covering an underwritten public offering of the company's securities and ends a specified time (e.g., six months) after the effective date for filing the registration. The company must be actively employing in good faith all reasonable efforts to cause the registration statement to become effective in order for the restrictions on the investors' rights to apply.

The second major issue relating to demand registrations concerns the size of the offering. This item is controlled by imposing minimum standards on the percentage-in-interest of the holders of the registration rights who must combine to make the demand upon the company, as well as on the size of the proposed offering.

The registration rights provisions may require, in order for a demand to be effective, that:

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• The offering is made by holders of over fifty percent of the registrable securities; and

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• The offering cover sales of registrable securities worth at least $5,000,000.

The registration rights provisions may define the minimum size of the offering, including requirements that:

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• The offering cover at least a specified percentage of the registrable securities;

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• The offering exceed the greater or the lesser of an agreed dollar amount or percentage of the registrable securities; and/or

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• The initial public offering price equal or exceed a specified minimum dollar amount per share.

The percentage in interest of the holders necessary to effect a demand varies widely in purchase agreements, ranging from as low as twenty-five percent to as high as seventy percent in interest. It is generally a function of the total number of demand registrations available to the holders (i.e., the larger the number of demands, the lower the percentage in interest required to effect a demand).

The percentage of the registrable securities required to trigger a demand registration will depend on the composition of the investor group. The percentage should be set at a level which is high enough to prevent a small group of investors from requesting a demand registration which most of the investors believe is not in the best interests of the company.

The demand registration right provisions should address the number of demand registrations which the investors will be entitled to request over the term of the agreement. As noted above, the size of offering requirements and number of demand registrations are related.

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• As a general rule, investors will seek a sufficient number of demand registrations to ensure that they are able to dispose of most of their registrable securities over a reasonable period of time.

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• In many cases, investors will agree to accept only one or two demand registrations in return for the agreement of the company to permit investors to request an unlimited number of Form S-3 (§ 156:137) registrations.

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• In some cases, a cap may be placed on the number of requests which can be made during any calendar year and/or over the full term of the registration rights.

2. Company Registration

Piggyback registration rights obligate the company to notify the holders each time that the company proposes to register any of its securities and to include in such registration all the shares that the holders specify in a written notice back to the company within a specified period of time (e.g., 20 days) after the holders first receive the registration notice from the company. In the event that the proposed registration pertains to an offering which is to be underwritten, participation by the holders will depend on their agreement to the terms of the underwriting arrangement. Even if there are holders that elect to participate in the registration, the company has the right to terminate the registration at any time prior to the effectiveness of the registration statement.

It is generally best if the company attempts to include all registration rights in one investors' rights agreement, thereby reducing the possibility of a conflict between the rights granted to different groups of shareholders. If a single agreement cannot be arranged, then an effort must be made to reconcile the rights granted under each of the agreements.

For example, if one group of shareholders already has demand or piggyback registration rights, the subsequent agreement might include a provision which makes it clear that the piggyback rights granted thereunder are to be subordinate to the rights of the prior shareholders to include all of their shares in any demand registration which such prior shareholders might initiate.

The notice period provided to investors to decide whether to participate in an offering is generally set as short as possible, since once the registration process has begun, it is important to avoid any significant delays while investors determine whether or not to include shares in the registration. In many cases, notice to the investors will be accompanied by a request to waive the full duration of the waiting period, and waiver is usually facilitated by provisions in the investors' rights agreement which permit a specified percentage-in-interest to waive the rights of all of the investors.

As noted above, piggyback registration rights are subject to a variety of conditions and limitations.

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• They do not apply to any registration of company shares pursuant to employee benefit plans or for the purpose of issuing such shares in a merger.

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• The number of shares which a holder may include in any piggyback registration may be limited by the underwriters, in which case it will be necessary to allocate the shares among the company and all of the shareholders wishing to participate.

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• Where the piggyback rights are triggered by the company's intent to file a registration statement covering shares which are held by other shareholders, the piggyback rights may be subordinated to the rights of the other shareholders, who may have a provision in their registration rights which prevents other holders from including any shares in their registration until they are able to register all of their shares.

As a general rule, investors will have unlimited rights to piggyback on company registrations so long as their shares are deemed to be registrable securities. If the company is concerned about the administrative inconvenience of continuously providing notices of registration to every holder of registrable securities, it can bargain for some limit on the piggyback registration rights, such as:

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• Provisions which excuse the company from delivering a notice of registration to investors that may have failed to participate in a specified number of prior registrations; and/or

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• Provisions which reduce the number of shareholders eligible for piggyback registrations by providing for termination of such rights when the shareholder is able to sell all their shares in a single transaction without registration.

In some cases where the company has initiated a registration of shares for its own account, the underwriters will advise that it is necessary to exclude all secondary shares from, or limit the number of secondary shares included in, the offering.

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• In the case of the initial public offering of the company's shares, investors will generally agree to any limitation on the size of the secondary offering recommended by the underwriters, including a decision to exclude all selling shareholders.

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• However, after the company has gone public, the investors will usually insist upon some minimum participation in any company-initiated registration.

For example, it is common to find that investors will agree to a reduction in the size of the secondary offering in such registrations, provided that the aggregate value of the shares which are to be included in the registration by the shareholders of the company (including the investors) may not be reduced to less than a specified percentage (e.g., 25%) of the total value of all the shares included in such registration.

Limitations on the number of secondary shares included in a registered offering may be required in order to ensure that the market for shares sold by the company remains stable and organized following the offering.

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• If the offering is successful and there is sufficient demand for the company's shares, it may be possible to make a secondary offering as part of the "over-allotment" option that will be given to the underwriters in order to allow them to purchase additional shares in order to meet the requirements of the marketplace.

•

• In such cases, the first public distribution will essentially be shares sold for the account of the company and the second public distribution will be shares owned by shareholders of the company exercising their piggyback registration rights.

Underwriters' limitations on the number of shares which can included in a registration upon exercise of piggyback rights are generally referred to as "cut backs." It is possible to allocate the burdens of any cut back in a variety of ways. The most common method is to divide the registration opportunity among all the prospective selling shareholders pro rata based upon the number of shares owned by each shareholder. However, certain shareholders may be given a priority over other shareholders. For example, the rights of the founders and other employees to have their shares registered will usually be subordinated to the registration rights of the investors.

3. S-3 Rights

Investors are generally provided with the right to request that the company register their securities on Form S-3 once the company satisfies the conditions for the use of that form. Since Form S-3 is a substantially abbreviated form of registration that relies on the incorporation by reference of information which the company has already filed with the SEC (e.g., annual and quarterly reports on Forms 10-K and 10-Q), there are usually less strenuous limitations imposed on Form S-3 registrations. However, since any large distribution of securities may have a potentially adverse effect on the market for the company's securities, the company will negotiate for the ability to defer a Form S-3 registration under circumstances similar to those which might apply to requests for a registration on Form S-1 (§ 156:135).

Once the company is able to use Form S-3, the investors will have the right to request registration of their shares on such Form, subject to:

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• Any minimum size of offering requirements; and

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• The company's rights to delay the registration in certain circumstances.

The procedures used in the case of demand registrations on Form S-1 (§ 156:135) with respect to notifying other holders of registrable securities, preparing and filing the registration statement, and underwriting arrangements will also apply to every Form S-3 demand registration.

The company should not forget that Form S-3 registration statements can still be quite time-consuming and can expose the company and its managers to additional liabilities. In many cases, the SEC will use the filing of a Form S-3 registration statement as an opportunity to review the company's Exchange Act filings and may actually make a number of substantive comments which will require some time and expense to address, both as part of the registration statement and through amendments to the previously filed reports. The ability of the investors to rely upon Form S-3 registration rights will depend upon the quality of the disclosures made by the company in its periodic reports, most of which will be prepared without assistance or comment from the investors or any of the underwriters who might eventually be involved in the distribution.

The scope of the Form S-3 registration rights will vary depending on the circumstances. For example:

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• The agreement may provide that the holders may not request more than two Form S-3 registrations during any calendar year and that the total number of Form S-3 registrations cannot exceed four over the entire term of the rights.

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• The Form S-3 demand registration rights may simply terminate after a specified period of time (e.g., five years after the date of the company's initial public offering).

4. Expenses

Once the parties have reached agreement regarding demand and piggyback registration rights, a decision must made regarding the allocation of the fees and expenses associated with registering and distributing the securities. The term "registration expenses" is generally defined to include all expenses, other than underwriting discounts and selling commissions, that are incurred by the company in complying with its obligations to the holders under the terms of the registration rights agreement. Covered expenses include such things as:

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• Registration fees related to federal filings;

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• Fees and expenses related to compliance with state securities laws;

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• Printing expenses;

•

• Legal fees; and

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• Audit fees and expenses.

In some cases, registration expenses may be expanded to include the reasonable fees and disbursements of counsel for the holders, although the company's obligation to pay the legal fees of the selling shareholders is generally subject to a number of strict limitations.

The key issue with respect to registration expenses is the extent to which such expenses will be borne by the company:

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• In this form, the company has generously agreed to bear all the expenses associated with exercise of the registration rights.

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• Another popular alternative calls for the company to bear the expenses associated with the demand registrations on Form S-1 and all of the piggyback registrations, and for the holders to bear the expenses of Form S-3 registrations.

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• In some instances, the company's obligations with respect to payment of expenses for demand registrations on Form S-1 will be limited to the first demand registration, and the investors will be required to pay the registration expenses of any subsequent demand registration.

Whenever the holders are to be held responsible for registration expenses, such expenses are usually allocated among them pro rata based on the number of shares that they are including in the registration. However, in some cases, the holders will only be obligated to bear the incremental expenses associated with including their shares in the registration.

5. Transfer of Rights

This form provides for free transferability of registration rights; however, some companies will argue that registration rights may not be transferred unless the transferee receives a certain minimum number of shares of "registrable securities." Another method for restricting transfers is to provide that registration rights will not accompany securities which could otherwise be sold immediately under Rule 144. The rationale for the restrictions on transfer is to reduce the duties of the company to provide notice to holders of registration rights.

6. Standoff Provision

Almost every form of registration rights will include a "market standoff" or "lock-up" agreement pursuant to which some or all of the investors will agree to refrain from making any sales of the company's securities outside of a registration statement for a specified period of time following a public offering with respect to the company's securities. Provisions of this type are necessary in order to give the company's underwriters some assurance that the market for shares sold in a registered public offering will not be adversely affected by the "overhang" created by the possibility of a substantial volume of sales of unregistered securities after the offering commences. Since the underwriters will require agreements of this type from officers, directors, selling shareholders, and any other major shareholders as a condition of the underwriting, it is useful for the company to obtain a contractual commitment from the investors at the time of the financing.

The key issues with respect to the market standoff agreement include:

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- The duration of the restriction;
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- The offerings to which the agreement will apply; and
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- The investors that will be subject to the obligations.

As to duration, sales will generally be restricted for at least 90 days following the offering and the period may run as high as a year for offerings involving a thinner, more volatile market. The market standoff may apply to each public offering of the company's securities. More typically, investors negotiate for limiting the agreement to the company's initial public offering, although major investors will recognize that the underwriters will probably seek a lock-up agreement from them for each subsequent underwritten public offering. While some market standoff agreements only apply to major shareholders (e.g., 5% shareholders), it is not uncommon for the agreement to cover all of the investors, including the holders of very small amounts of registrable securities.

The duration of the lock-up will depend upon the size of the offering and market conditions. For most venture-backed companies, the lock-up period will be established at anywhere from 120 to 180 days for the company's initial public offering, although for some smaller offerings the period my be extended to 270 days. It is not uncommon for the underwriters to release some of the shares for sale prior to the end of the lock-up period, if market conditions permit.

7. Future Registration Rights

The investors will be concerned about the possibility that the company may grant additional registration rights in the future that might adversely affect the registration rights of the investors. As such, the investors will seek to impose limitations on the grant of future registration rights.

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• The investors may seek to prohibit the company from granting any registration rights unless they are subordinate to the rights of the current investors. The company may resist such a provision, however, since it wants the greatest flexibility in the event it needs to raise additional funds from new investors in the future. A common solution is a covenant that the company will not grant more favorable rights to future investors without obtaining the consent of the current investors. This is the provision used in this form.

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• Other alternatives include requirements that subsequent rights must be pari passu to those granted to the investors under this agreement and/or that the company covenant not to take any action that amounts to an adverse change in the rights granted to the investors.

•

• The strongest provision would prohibit the company from granting any such rights unless they are subordinate to the rights of the current investors. Subordination is rarely defined in detail, but is generally assumed to mean that the investors will have priority over future shareholders with respect to initiating a registration and including shares in any future registration. A subordination provision would mean that in the event of any future company-initiated registration, the desires of the first group of shareholders to piggyback on such registration must be satisfied in full before shares of the later group can be included.

•

• Another method would be to permit the company to grant the new investors separate demand registration rights, provided that the demand rights could not be exercised prior to a specified date, which would be fixed at some date after the original investors have had an opportunity to use their demand rights. While the new investors might object to such a restriction, they might agree if they could include some of their shares in any demand registration initiated by the original investors.

8. Other Provisions

In addition to the matters discussed above, the actual agreement (e.g., investors' rights or registration rights agreement) will also cover various other issues, including:

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• Registration procedures;

•

• Indemnification;

•

• Investors' obligation to disclose information to the company;

•

• SEC Rule 144 reporting requirements;

•

• Allocation of registration opportunities; and

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• Delays in registration.

Definitions are also typically covered in a separate section of the agreement.

It is important to reach agreement as to which shareholders of the company will be included in the group of holders under the registration rights provisions. If at all possible, the company will attempt to have a single set of registration obligations as to shares held by its shareholders, even though the company may have completed two or more rounds of financing with different groups of investors.

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• A single set of registration rights avoids conflicts between shareholder groups with different rights, such as might occur when two shareholder groups make a simultaneous request for their shares to be registered.

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• One master agreement consolidates all of the company's obligations with respect to notices and various other matters.

D Right of First Refusal

Investors may be given the right to participate in future company financings, thereby allowing the investor to maintain or increase its ownership interest in the company. Future participation rights may take the following forms:

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• A right of first refusal to purchase all of the securities offered by the company for financing purposes in the future, with each investor allocated the right to purchase a pro rata share;

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• Preemptive rights, which allow investors to maintain their pro rata ownership percentage after the financing has been completed; or

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• The right to discuss financing opportunities with the company before negotiations begin with any third parties.

While participation rights are commonly granted in private placements, companies generally find them to be quite burdensome, often leading to added expense and delays in obtaining new funding in the future. As a practical matter, the company almost always will consult with existing investors regarding future financings and the investors will usually waive their formal participation rights once an informal agreement has been reached regarding the allocation of a share of the new financing to existing investors.

Moreover, a right to participate in future financings means that the company must make an offer to sell to each holder of the right. As such, care should be taken to comply with all applicable securities laws whenever there is a need to comply with the participation rights procedure. This is one reason for limiting the participation rights to a small group of large investors. The participation rights may be considered preemptive rights under the applicable state law and, as such, must be set out in the articles or certificate of incorporation in order for them to be enforceable.

Procedures for waiving the participation rights provisions with respect to a specific financing are almost always included in the agreement. While waiver procedures are generally intended to facilitate the rapid completion of future financings, they can have the effect of depriving some of the investors of the opportunity to increase their investment in the company. The actual percentage-in-interest of the investors required to waive the participation rights is always carefully negotiated, and major investors may want to set the percentage at a level which allows them to control any future waiver decisions.

E Board of Directors

As a general rule, the election of directors will follow the principles of "one share-one vote," unless some other provision as to the election of directors is included in the charter documents. Most states permit cumulative voting by shareholders in the election of directors. Whenever a cumulative voting provision is authorized by statute or the articles of incorporation, covenants should be included in the articles or bylaws which prevent the company from changing the size of the board of directors without the consent of the investors.

Private investors, particularly venture capitalists, may have a great interest in actively participating in the management of the corporation through membership on the board of directors. The degree of participation will vary depending upon the circumstances.

- • The investors may be content to elect a minority of the members of the board.
- • In other cases, the investors may insist upon the right to name a majority of the directors.
- • Both the investor group and the company's founders and managers may have equal representation on the board, perhaps with the added option of allowing the designated directors to appoint additional independent board members.

There are a number of pros and cons to be considered by management with respect to the degree of control which will be given to the investor group:

- • Investor participation on the board provides a good method for insuring that the investors are kept apprised of corporate activities and for building a strong consensus on appropriate business strategies.
- • The investor members may be able to provide assistance in recruiting independent members of the board who can bring additional expertise or business relationships to the company.
- • Management may believe that investor control of the board will impair their ability to make key strategic decisions.

If the investors are not initially given the right to designate a majority of the board of directors, they may bargain for ability to assume control of the board of directors upon the occurrence of certain events specified in the charter documents. The triggers for these "vote switch" provisions, named so since they effectively switch control over the company's affairs from existing management to the investors, are always the subject of intense negotiations. In some cases, changes in control may be limited to the following situations:

- • Failure to make required redemptions;
- • Failure to make dividend payments; or
- • Conditions of insolvency or bankruptcy.

The parties may specify additional events, including:

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• Defaults under covenants contained in the charter documents;

•

• Defaults under covenants contained in the charter documents or investment documents; or

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• Failure to satisfy specific financial tests.

Vote switch provisions generally set out the procedures to be followed upon the occurrence of an event of default, including the requirement that the company notify the preferred shareholders of the particular event.

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• Once notice has been delivered, a meeting of the shareholders is convened, or an action by written consent is taken, in order to reconstitute the board of directors.

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• Once the new directors have been elected, they generally will continue to serve in that manner under the event of default has been cured, at which point the special rights granted to the investors under the vote switch provisions will terminate.

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• However, if there is any subsequent event of default, then the vote switch provision will come into effect once again.

If an investor is not to be represented on the board, the investor still may be given the right to attend board meetings as a non-voting “observer” and to receive notice of meetings and any written materials distributed to the directors. Since the members of the board, including investor designees, generally seek to limit the number of persons at meetings, observer rights are usually only granted when the investors have a significant position in a specific round of financing.

F Key Man Insurance

It is often considered desirable to have the company obtain and maintain term life insurance policies on lives of designated key employees of the company. In some cases, the investors will insist that this key employee insurance coverage be in place prior to the closing. Generally, it is sufficient to obtain a covenant that such coverage will be effective within a specified period of time (e.g., 30 to 60 days) following the closing. This type of insurance is intended to provide protection in the case of the death of a key employee, since such an event may seriously impair the company’s ability to obtain further financing. The proceeds of the policy are almost always payable to the company. Some investors require that the proceeds be payable to the investor group or be used by the company to redeem the investor’s shares. The company will generally provide a covenant to the effect that it will maintain the life insurance policies for a specified period of time and not cancel them without obtaining the investors’ consent. Alternatively, an insurance trust agreement can be established to insure that the company uses a portion of the proceeds received in the offering to maintain the desired insurance coverage of the key employee(s).

G Purchase Agreement

This section simply makes it clear that all the agreed terms and provisions described in the term sheet will ultimately be set out in a definitive stock purchase, or investment agreement. See Master Form at § 156:164. The parties should reach agreement on the procedures for amending the terms and conditions, including the percentage-in-interest of the investors who must consent to any amendment or modification. There may be situations in which an important investor or group of investors insists upon a higher percentage as a means of obtaining greater bargaining power with respect to any subsequent amendments or waivers.

III Employee Matters

The founders, as well as the other human resources of the business, are key factors in the execution of the business plan upon which the investment is made. This section covers a wide variety of employee-related matters, including:

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- Equity;
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- Compensation matters;
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- Restrictions on transfer of shares, and
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- Employment agreements.

A Employee Pool

Another important element of the investment relates to equity participation by founders and other employees of the company. The parties must first consider the total proportion of the ownership of the company to be allocated to founders and key employees. As a general rule, not all of the shares which are to be made available to employees will be sold and issued at the time of the financing and both the founders and investors are usually willing to suffer some dilution of their respective equity interests in the company in order to attract and motivate key employees.

The size of this "employee stock pool" for future issuances will vary and generally ranges from 5% to 15% of the fully diluted equity. Issuances of that number of shares will be exempted from any negative covenants, anti dilution provisions, or rights of first refusal relating to future share issuances.

The number of shares made available for the employees relates to the "pricing" of the entire transaction, since investors generally purchase securities in return for a specified percentage of the ownership of the company, after allowing for issuance of some amount of shares to employees for incentive purposes.

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- If the current value of the company's business, prior to the financing, is estimated to be $2 million and the investors are willing to contribute an additional $2 million, it may be reasonable to assign one-half of the post-financing ownership to the investors and one-half to the founders and other key employees who own the business prior to the funding.
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- If both sides believe that additional shares equaling 10% of the equity outstanding immediately following the financing will need to be issued in order to attract and retain new employees, that number of shares will be set aside as the "employee pool" and excepted from any right of first refusal or anti-dilution provisions.

New employee stock arrangements may either take the form of outright purchases, which require that the employee must actually pay for the securities, or option grants, which allow the employee to defer payment until a later date while providing the employee with some direct interest in future appreciation of the value of the company.

Some investors prefer to see that employees actually purchase the shares, believing that this builds a greater commitment to the company than the use of options. On the other hand, it may be difficult for some employees to purchase shares of the company, even when sold at “bargain prices.” If the company is unwilling to provide loans to employees for share purchases, it may be better to simply grant options.

B Founder Vesting

Vesting is an issue typically raised in connection with shares to be issued to employees in the future. See Employee Vesting (§ 156:149). However, vesting is also an issue for “founders,” even in situations where they have already held their shares for a significant period of time. If the company has been in operation for some period of time and the founders and key employees have already made a significant level of contributions to the company, many investors will agree to exclude a portion of the founders’ and key employees’ shares from the vesting provisions when putting new money into the company. For example, if a founder has been active with the company for two or three years and has drawn a salary that is well below that which she might have received at another firm in order to fund the business’ activities, the investors may agree to limit the vesting provisions to only 50% of the founder’s shares and to allow those shares to vest over the next two years, rather than the typical four years.

C Employee Vesting

Shares issued to employees, either outright or upon the exercise of options, will be subject to “vesting” restrictions which require that an employee must remain in the employment of the company for a specified period of time before the employee becomes entitled to the full economic benefits of owning the shares. If the employee leaves the company prior to the date specified in the agreement, the company would have the option to repurchase that portion of the employee’s shares which have not vested prior to the date of departure. The repurchase price for these unvested shares is generally equal to the price originally paid by the employee for the shares, although in some cases the employee will also receive an additional amount in the form of interest on the original price from the date of purchase. The key issues relating to vesting provisions are:

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- • The vesting period;
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- • The rate of vesting; and
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- • The events which will trigger the company’s option to repurchase the unvested shares.

The primary purpose of vesting provisions and associated repurchase rights is to provide a mechanism for the founders to “earn” their equity by continuing to work for the company. In most cases, the founders will have purchased their interest in the company for a nominal or relatively low purchase price, usually at a price per share much less than the current market value of the shares inherent in the price paid by the investors. The investors have an interest in ensuring that the founders continue to serve the company and help generate the returns anticipated by the investors before the founders are able to capitalize on the appreciation in their interest created by the financing.

There are a myriad of combinations which can be used in establishing the vesting period and the rate of vesting. Many outside investors have their own preferences, which are expressed during the course of negotiating the terms of a financing arrangement.

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- • As a general rule, vesting occurs over a period of four to five years.

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• In most cases, none of the shares will vest until the employee has been with the company for a specified period of time.

Once the employee has been with the company for the agreed-upon minimum period, a portion of the shares will vest and the remaining shares usually will continue to vest on a linear basis over the remainder of the vesting period. For example, none of the employee's stock may vest for the first two years of the purchaser's employment, but then 50% of the shares will vest when the two-year period is completed. Thereafter, the remaining 50% of the shares might vest at the rate of two percent a month for the next 25 months, although it is possible to use daily, quarterly or annual vesting.

D Restrictions on Sales

This provision places an outright restriction on certain sales of shares which might otherwise be made by the founders and other named employees. The provision compliments the right of first refusal (§ 156:151) that would apply to sales that are not otherwise restricted by this provision. And, if co-sale provisions (§ 156:157) are used, the effect is to further limit the ability of the founders to obtain liquidity for their shares without offering the investors an opportunity to participate.

E Right of First Refusal

This section includes a right of first refusal provision with respect to attempted transfers by the founders and other named employees. In this case, the right of first refusal goes to the company (or its assignees); however, it is not uncommon to provide that shares not purchased by the company may be offered to the investors. Investors rarely will agree to have their shares subject to a right of first refusal.

While this provision is structured as a "right of first refusal," consideration should be given to the use of an option to acquire, sometimes referred to as a "right of first offer." Under an option provision, a founder wishing to find a buyer for his or her shares must first offer the shares to the company for a specified price and terms.

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• If the shares are not acquired by the company, the founder may seek out and sell the shares to a third party at a price and for terms no more favorable than those offered to the company.

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• An option is disadvantageous to the company since once it has declined to purchase the shares the founder is free, at least for the period specified in the restriction, to sell the shares to any third party.

The primary goal of the right of first refusal is to ensure that the company's shares remain closely held and, in any event, out of the hands of persons or entities with interests which may be adverse to the company, such as competitors. The company's ability to exercise the right of first refusal may be limited by state corporations law restrictions on distributions to shareholders, and the company should negotiate the right to assign the right of first refusal.

F Proprietary Information and Inventions Agreement

The employee confidentiality and assignment of innovations agreements are designed to protect the company's trade secrets and insure that the company has the right to own and use any intellectual property which may arise out of the employee's activities on behalf of the company.

Investors will usually request that the company provide a covenant to the effect that all current and future employees of the company will be required to execute an employee confidentiality and assignment of innovations agreement. It has become customary to attach the form of agreement as an exhibit to the documentation for the investment.

G Non-Competition Agreement

The founders and key employees may be asked to enter into non-competition agreements which attempt to restrict their ability to engage in activities that might compete with the company's business plan and interests. The enforceability of such an agreement will depend on applicable state law; however, companies may usually prevent employees from conducting activities that might result in an unauthorized use of the company's confidential information and trade secrets. Key issues with respect to a non-compete agreement include:

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- • Geographic scope;
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- • Duration; and
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- • The types of activities to be covered under the agreement.

IV Other Matters

This last section covers a variety of miscellaneous matters, including conditions to closing (§ 156:154) and legal fees and expenses associated with the transaction (§ 156:156).

A Conditions Precedent to Financing

The term sheet is only the first, albeit an important, step in completing the transaction and the parties need to carefully list all other conditions precedent to completing the transaction. Of course, the parties must negotiate a definitive agreement; however, other conditions may also be included. For example, the investors will generally insist on the right to withdraw their commitment if they are not satisfied with the results of their due diligence review. And, in cases where the founders are being asked to enter into new employment agreements, closing will depend on completion of those agreements.

B Finders

Companies, and sometimes investors, will contract with finders to assist in the financing process. This provision make its clear that the parties will bear responsibility for any fees which must be paid to a finder in connection with the transaction.

C Legal Fees and Expenses

Both the company and the investors will incur legal fees and expenses in connection with negotiating the terms of the financing and drafting the various documents which will be required in order to complete the transaction. Most investors will insist that the company pay at least a portion of the legal fees associated with the engagement of special counsel. While the company is willing to do this, or compelled to agree in light of the bargaining strength of the investors, it will attempt to place some limitations on the obligation.

Many agreements contain a cap on the fees which the company will pay.

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- • It is now rare that a company will agree to bear more than $15,000 of legal expenses for the investors, and the cap is often set much lower (e.g., $5,000) for later round financings where the investors are familiar with the company and the documentation is quite similar to that used in earlier rounds.
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- • Similarly, a lower fee cap will be appropriate when company counsel is responsible for preparing the documents and circulating them among the members of the investor group.

While, in most cases, the cap covers fees and expenses incurred by counsel to the investors, some investors' counsel will argue that expenses, such as xeroxing copies of the agreements and transmitting them to each of the investors, should be exempt from the cap, since they would have been incurred by the company in any event.

Special care should be taken in assigning responsibility for the legal fees and expenses of investors in those situations where there is a large group of investors and some of the investors want the document reviewed separately by their own counsel. In almost all cases, the company will only be willing to cover the fees and expenses of a single counsel for the investors, although there are some situations, such as when a substantial portion of the entire amount of the financing is coming from one institutional investor, that the company will also agree to pay a portion of the legal fees and expenses of that particular investor. If the lead counsel believes that there will be significant additional expenses associated with retrieving and conveying the comments of other counsel for certain investors, some upward adjustment in the cap on the amount to be paid by the company may be appropriate.

D Option: Co-Sale and Right of First Refusal Agreement

Management shareholders will be required to provide investors with the right to participate in sales which such shareholders may be permitted to make to third parties. The participation rights allocate the opportunity to sell the shares to the third party among the parties to the agreement in proportion to their ownership interests. The effect is to decrease the number of shares which the management shareholder is permitted to sell. These rights are generally referred to as "co-sale" or "take-along" rights and are designed to prevent management shareholders from "bailing out" on the investors by selling their interest to a third party without giving the investors the benefit of any increase in value from the sale. As a general rule, a sale to a third party which is the subject of a co-sale arrangement must first survive any right of first refusal (§ 156:151).

E Option: Marketing Agreement

Corporate investors may provide investment capital in exchange for preferred rights in other functional areas. This provision is an example of an arrangement which might be made in a corporate partnering deal and provides one of the investors with the right to market certain of the company's products. A separate description of the scope of the marketing agreement will need to be included in the investment agreement.

F Option: Drag-Along Rights

A "drag-along" right, sometimes referred to as a "bring-along" right, allows the holders of a specified percentage of the outstanding voting securities to force the other shareholders to agree to a sale of the company (including sales made in the form of a merger) and thus spare the acquirer from having to go through the time and expense of a freeze-out merger to obtain 100% voting control over the company. The following key issues need to be addressed when drafting this type of provision:

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• The minimum percentage share ownership of the shareholders who are able to trigger the provision should be carefully evaluated and should be no less than the percentage required in order to approve a merger or other sale transaction.

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• In most cases a drag-along right does not become effective for several years after the date that the investors acquired their shares. The founders will want to be sure that they have sufficient time to build the business and realize the return on investment that the investors expected before they are subject to the sole discretion of the investors as to the price and conditions of the sale of the company.

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• Shareholders forced to sell because of the drag-along right should receive the same form of consideration as any other shareholder and if any Shareholder is given an option as to the amount and form of consideration to be received each shareholder should be given the same option.

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• If the founders are obligated to first offer their shares to the investors under a right of first offer agreement that process should be completed or waived before the founders have any right to participate in the sale under the drag-along rights.

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• The provision should provide that if the proposed sale transaction requires shareholder approval (e.g., a merger), each shareholder will vote for the transaction and refrain from exercising any statutory dissenters rights that might delay the transaction or increase the cost of the transaction to the acquirer.

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• Each shareholder should be required to execute and deliver all related documentation and take such other action in support of the sale including, without limitation, executing and delivering instruments of conveyance and transfer, and any purchase agreement, merger agreement, indemnity agreement, escrow agreement, consent, waiver, governmental filing, share certificates duly endorsed for transfer (free and clear of impermissible liens, claims and encumbrances) and any similar or related documents.

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• Shareholders forced to sell because of the drag-along right should only be obligated to provide very limited representations and warranties (i.e., title to their shares and absence of conflicts) and should not be obligated to participate in any indemnity that the acquirer may require as a condition for consummating the transaction (other than indemnities relating only to the representations and warranties made by such shareholder).

G Option: No Shop

Since the investors will spend a substantial amount of time deciding whether or not to make a particular investment, and will incur expenses (including professional fees) during the course of their due diligence investigation, they will often want assurances from the company and its founders that they will refrain from actively soliciting competing offers to finance the business for a limited period of time so that the investors can complete their background checks, negotiate the details of the transaction and, hopefully, close the deal. A “no shop” clause restricts the company and the founders from “shopping” the deal for a specified period, say four to eight weeks, and calls for payment of a specified amount to the investors in the form of liquidated damages in the event of a violation of these covenants. The company and the founders should ask for, and it is reasonable for them to expect to receive, an undertaking from the investors that they will move forward toward closing in good faith and a breach of this covenant by the investors would allow the company and the founders to move to terminate the “no shop” clause before it would normally terminate.

H Option: Confidentiality

Both parties will have an interest in maintaining the confidentiality of the proposed terms of the financing and this provision may be used to ensure that representatives of the company do not disclose the term sheet to outside parties other than professional advisors and others expressly approved by the lead investor. This type of provision is sometimes integrated with the “no shop” clause since the investors obviously do not want to have the founders and senior managers of the company showing the term sheet to other investors and asking them for better terms.

Footnotes

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