VENTURE CAPITAL INVESTMENTS

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Table of Contents

Venture capital typically refers to high-risk private equity investments by financial or strategic investors in young companies with the potential for significant growth. This manuscript identifies and explains many of the substantive issues and terms associated with venture capital investments.

1. **Overview of Investment Documents**.[1]

(a) Stock Purchase Agreement.

The Stock Purchase Agreement is the document evidencing an investor's acquisition of securities in a target company. Typically, this agreement includes provisions regarding the amount of stock being acquired and the purchase price, the closing conditions for the purchase (including what documents and information must be delivered by the company to the investor at or prior to closing) and the representations and warranties made by the company and the investor.

The company's representations and warranties often include statements regarding, among other things, (i) the company's organization, (ii) its authorization to issue securities and the enforceability of the transaction documents, (iii) its capitalization, (iv) its financial status and performance, (v) any litigation to which it is subject, (vi) its compliance with laws, (vii) its employees and benefit plans and (viii) its assets, including intellectual property and contracts. Each investor typically will make certain representations regarding its status as an "accredited investor," its intent to hold and not distribute the purchased securities and its authorization to consummate the investment.

(b) The Portfolio Company's Charter.

Many venture capital investments take the form of a new class of preferred stock created for a particular round of financing. The company's charter (i.e., its certificate of incorporation) is amended prior to closing to describe the terms, rights and privileges associated with the new class of stock. The amended charter will contain provisions regarding (i) the designation of the new class of preferred stock, its par value and the number of authorized shares, (ii) the dividends to be paid in respect of the preferred stock, (iii) the voting rights and privileges associated with the preferred stock, (iv) the liquidation rights and preferences of the preferred stock, (v) the terms on which the preferred stock will convert into common stock, if applicable, and (vi) any protective voting provisions or other consent rights associated with the preferred stock.

(c) Other Agreements.

In many venture capital investments, the new investor will enter into some combination of an investors' rights agreement, a stockholders' agreement, a voting agreement, a registration rights agreement and a right of first refusal and co-sale agreement. These agreements typically include (i) a right of first refusal for the company and/or the new investors in respect of any sale of the founders' stock, (ii) co-sale rights for the new investors in respect of a sale of stock to a third party by a founder and/or other stockholders, (iv) preemptive rights for the new investors with respect to subsequent issuances of securities by the company, (iv) "drag-along" rights for stockholders representing a majority of the outstanding stock, pursuant to which they may force a sale of the company to a third party, (v) agreements among the stockholders to vote their shares in a prescribed manner, such as for certain director nominees or fundamental transactions, (vi) covenants regarding the post-closing operation of the company, typically relating to reporting and fundamental transactions and (vii) agreements regarding the registration rights to which the investors are entitled.

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[1] For ease of explanation, this manuscript assumes an investment in a corporation, rather than a limited liability company or partnership.

2. **Economic Terms**.

(a) Type of Security Purchased.

"Angel" investors, participants in a "friends and family" round of financing and founders often hold common stock in a company. Normally, a holder of common stock has one vote per share on each matter presented to the stockholders for a vote, receives dividends if and when declared by the company's board of directors and is last in line to receive proceeds in a liquidation of the company.

Most investments made by venture capitalists, however, are in the form of convertible preferred stock. A new class of preferred stock often is created for each round of financing. Preferred stock gives the investor certain rights and privileges to which the common stockholders are not entitled. For instance, holders of preferred stock typically have priority over the common stockholders with respect to proceeds distributable in a liquidation of the company. Preferred stockholders also may be entitled to fixed, cumulative dividends that will be paid prior to any dividends or distributions to the common stockholders.

Preferred stock often is convertible into common stock at the investor's election and automatically upon the occurrence of certain triggering events, such as a public offering or a sale of the company at an agreed-upon threshold price. In a liquidation or sale of the company, preferred stockholders often receive a return of their capital contributions to the company and any accrued and unpaid dividends. Additionally, they may share in the distributions made to common stockholders as if their preferred shares had converted into common stock.

Investors also may invest in debt securities that are convertible into stock or accompanied by equity warrants. In many ways, these investments are similar to convertible preferred stock that carries a fixed, cumulative dividend.

(b) Valuation; Price per Share.

A venture capitalist typically seeks to obtain the largest possible percentage of the company's equity in exchange for its investment. Conversely, the existing stockholders of the company (including the founders) desire to limit the amount of equity surrendered to the investor. Accordingly, the valuation of the company is critical in determining what percentage of equity will change hands.

The "pre-money" valuation is the agreed-upon valuation of a company prior to the making of an investment. The pre-money valuation plus the amount invested will equal the "post-money" valuation.

Sometimes, if the parties are unable to agree on the pre-money valuation, an investor may agree to a higher valuation, but require the company to meet certain performance milestones to substantiate it. If these milestones are not met, the ratio at which the investor's preferred stock converts into common stock may be adjusted to give the investor a larger share of the company. Alternatively, the investor could receive warrants with a nominal exercise price that are exercisable upon the company's failure to meet the performance milestones.

(c) Dividends.

Generally, the declaration and payment of dividends, whether in respect of preferred stock or common stock, is in the discretion of the company's board of directors. In many venture capital investments, however, the preferred stock is entitled to a fixed, annual dividend on the purchase price per share that will accrue and cumulate over time, whether or not declared by the company's board of directors. All accrued and unpaid dividends will be paid in full prior to any dividend payments or other distributions to the common stockholders. Additionally, the preferred stock will participate in any dividends payable in respect of the common stock.

With respect to cumulative dividends, investors often require that all accrued and unpaid dividends be paid upon the occurrence of certain triggering events. These triggering events may include, among other things, (i) a conversion of the preferred stock into common stock, (ii) the exercise of any redemption option in respect of the preferred stock, (iii) a liquidation of the company, (iv) certain fundamental transactions, such as a sale of the company, or (v) an initial public offering of the company's common stock.

(d) Liquidation Preference.

Preferred stock investments are structured so that, upon a liquidation or sale of the company or the occurrence of other triggering events, the preferred stockholders are entitled to a certain return on their investment prior to any distribution to the common stockholders. This return is the "liquidation preference." A typical liquidation preference equals the purchase price paid by the preferred stockholders for their shares plus any accrued and unpaid dividends thereon, as described above.

Liquidation preference rights vary depending upon market conditions and the parties' relative bargaining strength. At the pro-company end of the spectrum, a preferred stockholder may receive the greater of its investment amount (and any accrued and unpaid dividends) and the distributions it would collect if its preferred shares converted into common stock immediately prior to the liquidation event. This is known as "non-participating preferred stock."

At the pro-investor end of the spectrum, a preferred stockholder may be entitled to its investment amount (and any accrued and unpaid dividends) plus a share of the distributions made to the common stockholders on a *pro rata* basis, as if it had converted its preferred stock into common stock. This is known as "fully participating preferred stock."

In between the two ends of the spectrum, holders of "partially participating preferred stock" may be entitled to receive their investment amount (and any accrued and unpaid dividends) and participate in common stock distributions until they receive a specified multiple of the original purchase price.

(3) Anti-dilution Protection.

There are two types of dilution that an investor may incur after acquiring equity in a company: dilution in the value of the investment and dilution in the investor's percentage ownership of the company. Venture capital investments frequently include terms intended to minimize both types of dilution.

(a) Investment Value Protection.

Although a decrease in the value of an investor's stock is part of the business risk of investing, venture capitalists frequently expect some kind of protection against dilution that negatively impacts the value of their investment.

With respect to convertible preferred stock investments, this protection typically takes the form of an adjustment to the ratio at which the preferred shares convert into common shares. This ratio is expressed as (i) the purchase price paid for each preferred share, divided by (ii) a conversion price per share. A downward adjustment to the conversion price can mitigate or eliminate the effect of any dilution caused by the issuance of shares at a price lower than the investor's original purchase price.

The two primary forms of value-based anti-dilution protection are referred to as “Full Ratchet” and “Weighted Average.” Full Ratchet provides maximum protection to investors by adjusting the conversion price per share to the new price per share at which additional securities are issued.

If there is a subsequent securities issuance and existing investors have Weighted Average protection, on the other hand, the conversion price per price is reduced, but not completely to the new issuance price. Instead, the reduction is based on a formula that takes into account the number of shares being issued in relation to the company’s total equity capitalization.[2]

Notwithstanding the type of protection agreed upon by the parties, certain equity issuances typically are excluded from value-based anti-dilution protection, such as the issuance of options to employees up to a pre-approved “option-pool” percentage, warrants to financial institutions in debt financings and shares issued upon the exercise of existing common stock equivalents. Other exclusions, such as issuances to strategic investors in an acquisition, may be included as well.

(b) Percentage Ownership Protection.

A venture capitalist’s percentage ownership in a company will be reduced by future equity issuances. That does not necessarily mean that the value of the investor’s equity has decreased; in fact, it may increase. Rather, a diluted investor no longer holds the same percentage of equity in the company and is entitled to a reduced share of the company’s net earnings and assets.

While value-based anti-dilution protection helps to preserve the value of an investment in a subsequent down-round of financing, venture capital investors also seek protection against a decrease in their percentage ownership through participation or preemptive rights.

These rights give existing investors the opportunity to purchase their *pro rata* share (based on their existing percentage ownership of the company) of any securities to be sold by the company on the same terms and conditions to be offered to third parties. These rights enable the investors to maintain their percentage ownership and preserve their voting power. These rights also allow investors to participate in any “sweetheart deals” conducted at prices above their original purchase price but lower than fair market value.

Founders and other existing stockholders sometimes seek to subject the investors’ preemptive rights to a “play or pay” provision. These provisions impose penalties on investors who fail to exercise their preemptive rights in full. Typically, if an investor does not participate in a subsequent round of

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[2] A typical Weighted Average formula for determining the new conversion price is:

$$\text{NCP} = \text{OCP} * \frac{\text{OSPI} + \text{NSOP}}{\text{OSPI} + \text{NSAI}}$$

NCP	=	new conversion price
OCP	=	old conversion price
OSPI	=	number of outstanding shares immediately prior to the new issuance
NSOP	=	number of new shares that would have been issued at the old conversion price
NSAI	=	number of new shares actually issued

The formula assumes that all previously outstanding shares were issued at the old conversion price, and then fixes the new conversion price to the weighted average of the old conversion price and the price at which the new equity is sold.

financing, its preferred stock converts automatically into junior preferred stock or common stock at the pre-issuance conversion price.

(4) Corporate Governance Provisions.

An investor making a significant investment in a company typically expects to be involved in company operations in some capacity. Few venture capital investments give an investor majority control of the company's voting stock or board of directors, so the investment documents often provide the investor with various approval and inspection rights and opportunities to voice its views in company affairs. The scope of these rights will depend upon the relative bargaining power of the existing stockholders and the new investor and the size of the new investor's ownership interest.

(a) Board Participation Rights.

Frequently, an investor, group of investors or a class of stockholders will want the ability to designate one or more individuals to serve on the company's board of directors. An investor with a small investment may want observer rights in respect of board meetings if the ability to designate a director is not appropriate.

The company's charter and/or a voting or stockholders' agreement often will contain a provision stating that either (i) a class of stockholders may vote to elect one or more directors, or (ii) an investor (or group of investors) may nominate one or more candidates for the company's board of directors. In the latter case, the other holders of the same class of stock (or all stockholders) will be obligated to vote in favor of the person(s) nominated by the investor(s) to serve on the board. These board members may be removed only with the consent of the stockholders or investors who have the right to elect or designate them, so long as such right exists. This right may be linked to holding a certain percentage of the company's outstanding equity (which is another reason why preemptive rights can be important).

Investors should be mindful of directors' fiduciary duties when bargaining for the right to appoint a director. Such duties may obligate the designated director to take a position that is inconsistent with its interests of the investor, and could expose the investor and the director to unwanted litigation risk. Although investors may mitigate these risks by requiring the company to maintain directors' and officers' liability insurance and to indemnify the investors' board designees, many investors prefer board observation rights over board membership rights.

(b) Information Rights.

An investor often seeks certain information rights with respect to a company's business and affairs. For example, the company typically provides the investor with certain financial information on a monthly or quarterly basis, including audited and unaudited financial statements. The investor may have the right to receive and approve the company's annual budget and changes to its business plan. Additionally, a company usually is required to notify an investor of the occurrence of certain adverse events, such as (i) the default by the company under a material agreement, (ii) a material adverse change in the business or assets of the company and (iii) any litigation or governmental proceeding pending or threatened against the company. The documentation also may grant inspection rights to the investor, including the right to examine the properties, books and records of the company.

(c) Consent Rights and Protective Covenants.

A company's charter likely will contain provisions that limit the company's ability to take actions that substantially affects a venture capitalist's investment.

For example, the charter may include negative covenants on the company's ability to do the following without the approval of holders of majority of the preferred stock: (i) a liquidation or sale of the company; (ii) the creation or issuance of any capital stock senior to or pari passu with the preferred stock; (iii) the payment of any dividends or other distributions in respect of any junior security; (iv) the repurchase or redemption of any outstanding securities (including convertible securities); (v) the issuance of options, warrants or other convertible securities, except as expressly permitted under the company's existing or anticipated employee option plans; and (vi) the incurrence of indebtedness above a certain threshold, the encumbrance of the company's assets and the prepayment of any existing indebtedness.

The company also may be subject to certain affirmative covenants, including an obligation to maintain adequate property and casualty and directors' and officers' liability insurance, to obtain nondisclosure, noncompete and proprietary assignment agreements from its employees, and to take certain steps to protect its intellectual property.

(d) <u>Right of First Refusal</u>.

Customarily found in the stockholders' or co-sale agreement, a right of first refusal gives investors the option to buy stock to be sold by another stockholder (typically, a founder) to a third party at the price and on the same terms and conditions offered by the third party. Generally, a first-refusal right gives investors some protection against control or even minority rights being transferred to a third party with whom they are not familiar or comfortable.

Often, first-refusal provisions are drafted so that the company has the *first* right to purchase the shares to be sold. If the company exercises this right, the shares are redeemed and cancelled and every stockholder's percentage ownership interest increases on a *pro rata* basis. If the company declines to exercise its right, an investor or group of investors have a *second* right of refusal.

Some refusal rights may be exercised only for all, and not less than all, of the shares offered. This gives the selling stockholder protection against a piecemeal purchase by the non-selling stockholders that would effectively thwart the deal with the prospective third party buyer.

Certain transfers of stock customarily are excluded from a right of first refusal, including transfers to a related party of the stockholder, redemptions by the company and sales after an IPO. Sometimes, transfers to existing stockholders are excluded but not if such transfers would shift control of the company.

(5) <u>Exit Strategies</u>.

Every venture capitalist seeks opportunities to facilitate a liquidation of its investment at an advantageous time. In addition, venture capital fund managers are under pressure from their investors to realize liquidity events, return investors' capital and terminate the fund after a predetermined term of years. Although many investors hope to sell shares in the public market after a portfolio company has an IPO, many exit strategies focus on the ability to sell stock back to the company or to a third party. Typical rights requested by investors to effect their exit strategies include redemption rights, co-sale rights and registration rights.

(a) <u>Redemption Rights</u>.

Redemption rights give the investor the option to put preferred shares to the company after a period of time, or upon the occurrence of certain triggering events, at a predetermined price. Typically, redemption rights may be exercised only by holders representing a majority of the preferred shares. A frequent redemption price is the amount paid for the shares plus a return thereon like interest as if dividends had been declared and accrued but not paid.

In some cases, the company has the right to call the shares for redemption after a designated period; typically at least one year after the investor's redemption right may be exercised. An investor likely will require the company to pay a premium price if a call right is granted.

The value of redemption rights as an exit strategy is limited because the company may not have the financial ability to consummate the purchase. Accordingly, redemption provisions typically provide for the redemption price to be paid in installments. Additionally, the redemption provision may state that if the company is unable to redeem the shares, the investors will have the right to appoint a majority of the company's board of directors.

(b) Co-Sale Rights.

Co-sale or tag-along rights give an investor the ability to participate in sales of stock by founders and other significant stockholders. Co-sale rights often apply to any sale of stock regardless of size, but may apply only to situations where a substantial portion of the company's stock is being sold (e.g., at least 50% of the voting power or value of the company).

Frequently accompanying co-sale rights is the right of a stockholder majority to require the remaining holders to join them in a sale to a third party, known as "drag-along" rights. For tax, legal, or other reasons, either the buyer or the stockholder majority may prefer a stock acquisition rather than a purchase of assets or a merger, and the drag-along provision enables them to use such a structure.

(c) Registration Rights.

Registration rights enable investors to sell their shares in a public offering of the company's stock. Selling securities in the public marketplace pursuant to an effective registration statement gives the investor greater access to buyers and, potentially, a better price. Registration rights appear in a separate registration rights agreement or an investors' rights agreement.

There are two types of registration rights: demand registration rights and piggyback registration rights. Demand rights permit the investor to require the company to sell its stock in a registered offering. Demand rights often are subject to a waiting period from the date of investment, usually a term of several years. In many instances, demand rights are exercisable only after the company has an IPO. The agreement usually limits the number of demand registrations a group of investors may request (often one to three). Piggyback rights give the investor the right to participate in primary offerings made by the company, and usually are unlimited in number. Registration rights often will terminate after a specified time, such as five years following an IPO.

Registration rights agreements generally permit the underwriter of any offering to reduce on a *pro rata* basis the number of shares to be registered, which will result in a reduction in the number of shares an investor may sell. Venture capital investors, particularly in later rounds of financing, pay close attention to the priority of their registration rights and negotiate for no worse than *pro rata* cutbacks that apply equally to all classes of preferred shares. Investors typically request unlimited short-form registration rights, which would be available only after the company has undertaken its IPO and is able to file S-3 registration statements.

Without registration rights, an investor may sell its stock under Rule 144 promulgated under the Securities Act of 1933, as amended, after the company has an IPO. This rule provides a safe harbor for certain sales of stock by non-issuers. Under Rule 144, the investor must hold the shares for at least one year from the date of the preferred stock investment. When making sales after this one-year holding period, such sales must be made in unsolicited broker's transactions on the open market and are subject to certain volume limitations. Within any three-month period, the investor is permitted to sell a number of shares equal to the greater of 1% of the outstanding shares of the company (as shown by the most recent report or statement published by the company) or the average weekly trading volume of the company's stock for the preceding four weeks. The investor will no longer be subject to any volume restrictions after holding the shares for two years, unless the investor is an "affiliate" of the company. Affiliates generally are more-than-10% stockholders, executive officers and directors of the company. Unless selling under a registration statement specifically covering such sale, affiliates are always subject to the volume limitations under Rule 144, even with respect to stock purchased on the open market. Because of the significant flexibility provided by Rule 144, registration rights are not absolutely essential after an IPO, unless the investor is an affiliate of the company, needs the ability to sell shares before the expiration of the Rule 144 holding period, or needs to sell more shares at one time than permitted under Rule 144.

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