

Raising Capital

for the Emerging Business

by Michael J. Drooff
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3rd Edition

The logo consists of the letters 'SRBG' in a white, serif font, centered within a dark green square. The background of the entire cover is a light, blurred image of several stacks of silver coins.

SRBG

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Note

The discussion contained in this book is of a general nature and is not intended as legal advice to any person for any particular set of circumstances. Many of the laws and principles discussed in this book have technical requirements and exceptions which are beyond the scope of this book. Legal advice can only come from a qualified lawyer who is aware of all of the relevant facts and circumstances.

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Introduction

Emerging businesses have always faced obstacles that established companies do not. Establishing market presence, forging supplier and provider relationships, developing customer goodwill, gaining bargaining power, achieving economies of scale, coping with regulatory schemes that seem to favor established companies—these are all common, and perhaps unavoidable, difficulties which must be overcome by emerging businesses. Raising capital is also a major problem for start-up and emerging businesses with growth ambitions.

In recent years, however, the difficulties that emerging businesses face in raising capital have eased somewhat. Federal, state and local governments have increasingly focused on the need to enhance tax and employment bases and have recognized that small businesses make a disproportionately large contribution in these areas. Although regulation of business continues to be politically popular, federal and state lawmakers and regulators have attempted to carve out niches and exemptions to allow small and emerging businesses to raise capital more easily. In the private sphere, the capital markets have discovered the rewards of investments in emerging businesses, as part of their constant search for higher returns on capital. With the huge expansion in the equity markets since the early 1990s, investment managers have expanded the range of enterprises in which they are willing to invest. Even after the bursting of the Internet and telecommunications bubbles of the late 1990s, the market for startup and early-stage capital continued to be an important segment of the capital markets. Although the capital markets in 2008 and 2009 have undergone unprecedented turmoil, the difficulties that the markets face do not undermine the basis for the market for startup and early-stage capital.

Although the process of raising capital has become somewhat easier, it remains a very serious undertaking. Financial and strategic planning and related legal issues must be addressed with as much foresight as possible. A great deal of preparation must be performed with accuracy and discretion. In these times of great volatility in the capital markets, timing is often crucial. Unfortunately, missteps can have serious consequences, both for the emerging business and its

owners and managers. While the corporate and limited liability company forms of organization provide good protection for individuals from most types of claims by creditors, federal and state regulators and private plaintiffs in investor lawsuits are in many cases legally entitled to hold corporate insiders responsible for problems which arise under the securities laws.



Experienced legal counsel can play a crucial role in helping to raise capital for the emerging business. Far from being a mere scribe, a good corporate finance lawyer should be closely involved in formulating, structuring and implementing an effective capital-raising plan, in order to maximize effectiveness and minimize problems and delays. At Sheehan Phinney Bass + Green, we have a long tradition of assisting emerging businesses, whether they are raising capital or dealing with other concerns. We have prepared this book to outline, from both business and legal perspectives, how to approach the various methods of raising capital. We have included a discussion of each of the most important methods.

Although there are many ways to raise capital, we strongly believe that for each business there are right ways and wrong ways to go about it. We hope that this book will steer emerging businesses onto the right track.

Sheehan Phinney Bass + Green brings some unique benefits to the task of raising capital for the emerging business. As a full-service law firm, we have the expertise to handle any type of legal problem that might arise during this process. As counsel to companies and institutions of many different sizes, we also have the range of experience necessary to serve businesses in all phases of their growth. As a significant regional firm, we understand the ways that business and government operate in the major regional cities and on a national level. We welcome the opportunity to put these resources to work for you.

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Seed Capital Offerings

by Michael J. Drooff, Esq.

Most emerging businesses, particularly in the technology sector, require a substantial amount of capital to fund basic development work on a proposed product. Once basic development work is complete, additional capital is needed to test the product in market conditions and adapt its functionality to developing customer needs, before the emerging business can commence regular business operations. Often a patent application needs to be prepared and filed. The capital that is used for these purposes is typically referred to as “seed capital.”

Raising seed capital is one of the most difficult obstacles for an emerging business to overcome. Only the most risk-tolerant investors are willing to invest in an unproven technology or product, for which there may not yet be a viable market. In addition, the reward for a successful investment at this stage is very uncertain. At the seed capital stage, an exit strategy for investors is almost always a very remote conjecture. Investors in these types of offerings are often very difficult to find; they are commonly referred to as “angels” for the good fortune involved in finding them.

Managers of an emerging business seeking seed capital can be encouraged by developments in the lowest segment of the capital markets. Although still far from being organized, the market for “angel” capital has developed rapidly over the last decade or so.¹ According to the Center for Venture Research at the University of New Hampshire, angel investments totaled \$26.0 billion in over 57,000 companies in 2007, an increase of 1.8% over 2006.² The number of active angel investors during 2007 was 258,200 individuals. Sophisticated angel investors often are willing to provide seed capital, together with management and financial advice, to emerging businesses on relatively favorable terms. Although the rise of angel investing was associated with the general technology and Internet booms of the 1990s, angel inves-

tors are likely to remain a permanent part of the capital markets even after the ongoing downturn of 2008-2009.

Sources of Seed Capital

Sources of seed capital are endlessly varied and often difficult to identify. Managers who are fortunate enough to have means of their own may fund some or all of their seed capital requirements with personal resources. Although self-funding has obvious advantages due to its flexibility, it can also have disadvantages. Later-stage investors will often consider the identity of existing investors and the quality of independent board members in assessing an investment, and self-funding can give an emerging business an in-grown character. For most managers of emerging businesses which have the potential to grow significantly, personal funds can only provide a small portion of the necessary seed capital.

Many managers are able to tap well-heelied friends and family for seed capital.³ With personal connections, the manager of an emerging business can often arrange an investment on relatively accommodating and patient terms. Managers with a track record in a particular industry also will often have connections with other industry insiders who are prepared to trust the manager with seed capital. Although such industry insiders often are reluctant to give investment terms the same soft touch as friends and family, their participation may be extremely valuable for the practical advice and credibility that they bring to the business.

Angel and VC Resources in New England

Geographic areas associated with technology and other entrepreneurial communities have seen the rise of semi-professional angel groups. In Northern New England, the

¹ In the First Edition of this book, the authors noted the establishment of several promising electronic matching services for angel investments which operate through the Internet. Unfortunately, these matching services have not lived up to the high expectations that they initially generated. Due to the risks involved in angel investing, it remains a highly personal process, in which lead investors need to have high levels of trust in managers, and co-investors need to have high levels of trust in lead investors. These factors tend to be incompatible with Internet matching services.

² See the press release entitled “The Angel Investor Market in 2007: Mixed Signs of Growth,” undated, posted on the Center for Venture Research’s website at <http://wsbe.unh.edu/cvr>.

³ Venture capitalist often jokingly refer to these types of investors as “triple-F,” i.e. friends, family and fools.

Route 128 and 495 corridors have high-profile groups of angels, some of which revolve around universities. A number of other areas in Northern New England have also seen the development of angel groups, for example the Nashua Breakfast Club, the Portsmouth “eCoast” group and the Mt. Washington Valley First Run group. While the approach and the philosophies of these groups vary, they have frequently served as the source of good ideas and patient seed capital.

There are numerous resources available for those looking to obtain VC or angel investment capital in New Hampshire. The state’s two major universities – Dartmouth College and the University of New Hampshire – have resources on their respective campuses. Go to www.den.dartmouth.edu (Dartmouth Entrepreneurial Network) or wsbe.unh.edu/cvr (University of New Hampshire Center for Venture Research) for more information.

It hardly needs to be said that a startup business should almost always accept seed capital where it can find it. Perhaps the only exceptions to this rule are where the prospective investor does not meet the legal standards for participating in a private offering, either because he or she does not meet the test for “accredited investor” status under the securities laws or otherwise lacks the sophistication to understand and bear the risk of an investment, or where the prospective investor is part of the shady underworld of the investment community. The legal standards for participation in a private offering of securities are discussed under “Legal Considerations” later in this chapter. Whether a prospective investor is legitimate may be somewhat more difficult to determine, but shady investors follow certain *modus operandi* which we at Sheehan Phinney Bass + Green have come to recognize.

For example, an emerging business is sometimes approached by a firm claiming to be in the investment banking or venture capital (VC) business that is, in reality, a finder. Some of these firms may initially give the impression that they have the ability to provide the necessary capital themselves, but in reality only intend to act as agents to find other sources of capital. Some of these firms can, in fact, place an offering; others offer assurances that are never realized. They will often ask for up-front fees, which are ex-

plained as retention fees, fees for the preparation of offering materials, unaccountable expenses or some other item for which it would be difficult to hold them accountable. Managers of an emerging business should ask tough questions about the structure of the fees charged, the identity of the actual investors, the firm’s track record with private offerings and the firm’s licensure as a broker-dealer under the laws of the states in which it operates. Any unfavorable responses should put the emerging business on guard as to the firm’s *bona fides*. We at Sheehan Phinney Bass + Green are happy to review the status of proposed investors or finders.

Involving finders in a seed capital round presents some special problems for an emerging business. Sometimes it appears that using a finder is one of the few ways of gaining access to interested investors. However, even legitimate finders with a favorable track record carry a risk for the emerging business. The problem stems from the fact that finders carry out a function that is not adequately addressed by existing securities laws. Under existing securities regulations and interpretations, if a finder receives “transaction-related compensation,” i.e. a commission which is contingent on a successful sale of securities, he or she is required to register with the SEC as a broker-dealer under the Securities Exchange Act of 1934 (Exchange Act) and obtain licensure as a broker-dealer in the states in which he or she operates. Since broker-dealer registration and licensure present a substantial compliance and reporting burden for the large brokerage houses, a small finder cannot practically comply with these requirements, and most finders do not attempt to do so.

For an emerging business, the danger is that an investment arranged by a finder will not perform as expected and that the investors will sue both the finder and the emerging business to rescind the investment. Usually, the investor’s claim is that he or she was not properly apprised of a risk that was borne out, or was not able to understand and assess that risk. Although the finder is primarily liable to the investors in such a case, the emerging business may also face liability as a “control person” of the finder.⁴ Before involving a finder in a seed capital round, the manager of an emerging business should consult with counsel, who will be able to assess the regulatory status of the finder and advise the manager on risks and alternatives.

⁴Several provisions of federal and state securities laws impose liability on “control persons” to the same extent as the person primarily liable. Under those provisions, “control” is a very broad concept and is not by any means limited to majority owners, but rather, any person who has any practical influence over another. It is quite possible that an emerging business could be found to be a control person in relation to a finder.

Angel Investor Search Process

The manager of an emerging business seeking seed capital will usually find that it takes an active search process that spans several months to locate the right sources of capital. Although it obviously makes sense to follow up on expressions of interest from angel investors, the manager should take care not to curtail a wider search upon receiving preliminary expressions of interest from a particular investor or group of investors. Experience has shown that the “yield” of actual investors compared with the number of persons expressing an initial interest in an investment, is relatively low, for various reasons.

- Some angel investors make a hobby of “kicking the tires” on a large number of potential investments;
- Other angel investors may have (or may develop) their own liquidity problems, particularly in these volatile times; and
- Still other prospective angel investors may change their mind about an investment opportunity based on rumors or advice from other angel investors who are perceived as “smart money.”

The process of lining-up angel investors can be very unpredictable, as befits an activity as complex and idiosyncratic as early-stage investing. A wise manager of an emerging business will constantly seek alternative sources of capital, to cover the situation where prospective investors back out, and to provide the appearance and/or reality of competition among investors.

Some prospective angel investors will express interest in an investment without a clear picture of their investment goals and methods. A tentative decision to invest is often divorced from a decision on the investment instrument and the terms that the investor is willing to accept. However, both angel investors and the emerging business in which an investment is proposed are well-advised to always consider an investment in the context of particular terms. Although the quality of a management team and the viability of a business plan are obviously crucial factors, it is nevertheless important for the angel investors and the company to develop a long-range plan for a particular investment, such as whether the most likely exit scenario is a recapitalization, a sale or an IPO.

Often it will be necessary for an emerging business to take seed capital from several different investors. Most angel investors pay great attention to the need to diversify their investments, given the high level of risk that they are taking in emerging businesses. It may also prove beneficial to an emerging business to take investments from different investors, since multiple investors tend to diversify the business’ contacts in the capital and product markets. Of course, the greater the number of investors, the more cumbersome it may prove to be dealing with them. In the event that a charter amendment must be approved or a contractual consent must be secured from investors after the investment has closed, a large number of investors can delay a significant future transaction such as raising additional capital. In many cases, the emerging business will find a happy medium between a diversified, yet cohesive group of investors, based on industry characteristics and personal dynamics.

Choice of Entity

With the rise in popularity of the limited liability company form of entity (LLC), many founders of emerging businesses have been led to consider whether their entity should be formed as an LLC. As is common knowledge, LLCs are treated for most tax purposes as partnerships, in that the income and loss generated by the company are attributed and taxed directly to the investors rather than being taxed to both the entity and through it, the individual investors in a corporation. While it is certainly advantageous if profits are taxed once instead of twice, many other considerations bear on the issue of entity choice for an emerging business. For example, the emerging business may not be projected to show income for several years. Thus, the owners will not enjoy the advantage of a single tax on profits during this period. Of course, it may also be advantageous for owners to use losses generated by the emerging business, i.e. if they have other income that they believe they can shelter with the losses. But if the entity is projected to show losses, then investors may feel uncomfortable if they suspect that the business may be managed in part to suit the tax planning needs of the managers. When considering the use of an LLC, managers and investors should carefully review and assess profit and loss projections against the tax consequences to them and the other constituents of the company.

In considering the use of an LLC, an emerging business

should also take into account the added complexity and expense associated with that form of entity. The flexibility for which LLCs are famous also means that the LLC agreement is often lengthy, complex and difficult to understand. A manager who uses this form of entity should budget additional accountants' and lawyers' fees to draft and administer the agreement, to avoid potentially surprising negative tax consequences. For example, accounting for the members' capital accounts in the LLC on a periodic basis requires significant effort and expense. Employee equity plans are also much more complex to design and administer with LLCs than with a traditional corporate entity. Although many of the characteristics, for example, of an option plan may be replicated with a specially designed LLC membership interest, it is essentially a different interest from a corporate stock option.

Investment Terms

An emerging business typically locates the source of seed capital before determining the terms of the investment instrument. Many investment terms will be driven by the particular characteristics of the emerging business and the investor, such as the timing of funding, the composition of the board of directors and the exit horizon for the investment. Given the significant expense associated with preparing investment agreements, it makes sense to at least informally discuss investment terms before asking counsel to draft documents.

From the perspective of the emerging business, common stock is the ideal investment instrument for seed capital. By its nature, common stock provides plenty of room in the business' capital structure for priority equity instruments like preferred stock and subordinated debt to be issued in later rounds. Common stock also corresponds with the risk/return profile that many angel investors face. It obviously carries the highest risk of any equity instrument, but it also provides a high return in the event the emerging business ends up a runaway success.⁵ Common stock is often sold to investors of the friends and family variety.

Industry insiders and other shrewd angel investors will

often agree to take a junior preferred stock.⁶ These types of angel investors adopt some of the objectives and methods of VC investors, with whom they often deal themselves. A junior preferred stock will often carry a nominal dividend rate and have priority over common stock in the payment of dividends and liquidating distributions. However, this type of preferred stock will often allow the company to issue additional preferred stock with distribution rights that are senior to the junior preferred stock. In order to compensate the investor for the degree of risk assumed, an investor in preferred stock will typically also ask for some way of participating in the return to common stockholders, in the event that the emerging business is a success. This participation right may take the form of a warrant to purchase common stock at a discount to fair market value, a common stock conversion feature, or a "double-dip" feature allowing the preferred stock to receive, upon a sale of the company, its liquidation preference plus a portion of the liquidating distributions to which the common stock is entitled.

Angel investors sometimes propose to invest through a debt security, e.g. a "bridge note" or a short-term or demand note. Sometimes this debt is explicitly made convertible into the next set of equity securities to be issued by the emerging business, and sometimes an understanding along those lines is implicit. Both the emerging business and the angel investors contemplating such an arrangement should be wary of the possibility that the debt is effectively a bridge to nowhere. If the expected equity financing does not materialize, then the debt to the angel investors likely cannot be serviced or repaid, and the resulting legal insolvency of the emerging business will complicate its efforts to grow its business. This is a situation which is in nobody's interests.

An emerging business which is taking debt financing from angel investors should also recognize that the debt is characterized as a security for regulatory purposes. Thus, disclosure, private placement and filing considerations will apply to the financing. Numerous court cases have found that such non-commercial-grade debt is as much a security as common stock and subject to all of the same conditions

⁵ In a typical sale scenario, the debt and preferred stock holders have first claim on the sale proceeds, following which the common stockholders share pro rata among themselves in the remaining proceeds. If the sale price is high, then the common stockholders may have a large amount to share among themselves. Of course, if the sale price is low, then the common stockholders may be entitled to receive little or nothing, after the debt and preferred stock holders receive their preference amounts.

⁶ Holders of a senior preferred stock, by definition, are paid before holders of a junior preferred stock.

and restrictions under federal and state securities laws.

The expected term of the security that is issued by the emerging business represents one of the most important terms of the investment. Friends and family may be prepared to extend capital for an indefinite period, trusting the emerging business to liquidate the investment as and when feasible. However, sophisticated angel investors will often insist on some explicit exit mechanism for the investment, in much the same way that VC investors do. They will look at a realistic time period in which the emerging business' product will either prove to be a success or failure (for example five to seven years). They will then provide for some additional period for VC investors to exercise their exit mechanism. At the end of the investment period, they will have the right to either cause their stock to be redeemed by the emerging business or cause the emerging business to be sold and the sale proceeds paid to the investors. Whether or not such a right could ever be enforced in a court of law is usually beside the point; the existence of such a right usually gives an investor enough leverage to effectively precipitate a sale or liquidation of the company.

Ambitious founders of a startup business should carefully consider the capital structure of their business even before it is formed, taking into account the needs of potential VC investors at a later stage in the business' growth. For this reason, it is often advisable to authorize in the organizational documents some form of preferred instrument, with specific terms to be determined by the board as circumstances dictate. This type of instrument is often known as "blank check preferred" for the authority that the board is given to set its terms. Authorizing such an instrument at inception will avoid or minimize practical and investor-relations problems caused by later having to solicit votes on a charter amendment from a disparate shareholder group. It is also important to recognize that potential VC investors will generally view debt negatively, particularly to prior angel investors, on the business's balance sheet. Since debt represents a claim to the business's assets which ranks prior to preferred stock, VCs will often insist that it be converted into equity or deeply subordinated as a condition to any new investment.

When planning the capital structure of a corporation

formed under Delaware law, special caution is warranted. The Delaware corporate statute contains a complex and quirky formula for determining the annual franchise tax which Delaware chartered corporations must pay. In order to avoid an inadvertently large tax calculation, it is wise to involve an experienced lawyer in designing the corporate capital structure.

While circumstances will dictate how much room for negotiation the emerging business has over the terms of a seed capital investment, counsel can recommend legal and structural protections to existing owners and point out the benefits and disadvantages of various terms proposed by new investors. Although an emerging business typically has very limited ability to engage in power negotiations with new investors, an effective tool in those negotiations may be an insightful analysis of the results that flow from a particular set of investment terms. For example, a set of investment terms that provides management with little incentive to maximize shareholder return under a realistic exit scenario, can give management a powerful argument in favor of a modification to those terms. By pointing out realistic problems with a set of terms, sophisticated counsel can provide considerable benefits.

Management and Ownership Arrangements

One of the most important issues faced by management of an emerging business seeking seed capital is how much management and voting control should be ceded to investors. Angel investors will, appropriately enough, ask for a substantial percentage of the emerging business' voting common stock or common stock equivalents. These discussions will usually center on some notional value that the parties assign to the business at that point in time. That is, the angel investors may be interested in owning, for example, 20 percent of the emerging business for an investment of \$1 million, thereby implying a post-money value for the company of \$5 million. However, it is vital for both parties to consider what the overall ownership might be several years in the future, assuming that substantial additional capital will need to be raised, as is usually the case. Even a very optimistic company and its investors must plan around the prob-

ability that additional capital will need to be raised before the emerging business crosses the magical break-even threshold in its operations. The key question is not whether, but at what price, new capital will be raised. For more on this point, see “The Dilution Conundrum” below.

A disciplined approach to these ownership and management issues will suggest that management must have a majority or a large minority ownership position in the emerging business after a seed capital round. Without a large stake in the emerging business, the managers may feel (and act) like indentured servants to the other shareholders. But with a substantial stake, the managers will be properly incented to create value in the business. Also, sufficient room should be left in the capital structure to give subsequent VC or other investors a large minority interest in the business. In practice, these factors will suggest that angel investors should be given an ownership stake in the range of 10 to 25 percent of the expected future capital structure.

Angel investors will often ask for a board seat from which to monitor their investment. They may also ask for specific “blocking” rights, i.e. the right to approve or disapprove of major corporate decisions such as changing the essential business plan, issuing additional stock, merging with another business, declaring a dividend or share redemption or liquidating the business. Often it will be difficult for an emerging business to refuse a request by an investor for these rights. However, management of the emerging business should make sure that the company will be in a position to quickly make decisions regarding raising new capital when future circumstances require it. Enlightened angel investors should be persuaded that it is not in their interests to delay or hinder certain necessary initiatives.

Although angel investors typically are the first to raise the issue, the owners of an emerging business raising seed capital should carefully consider the range of options open to them regarding governance and ownership provisions. Many of these issues go directly to the heart of the emerging business’ capital structure and who stands to reap the rewards of a successful business. Many

What is a Security?

The definition of the legal term “security” effectively controls the scope of the federal and state securities laws and regulations. That is, if a given investment instrument is properly characterized as a security, it will be subject to some or all of the legal requirements of the securities laws. “Securities” include the obvious instruments, like stocks and bonds, but also include other opportunities to realize a profit based on the managerial skill of the people who are entrusted with an investor’s money. The courts have also found non-commercial debt to be a security for regulatory purposes, even if nominally secured by collateral. Only a qualified securities lawyer will be able to determine whether a particular investment arrangement is properly considered a security.

businesspeople do not sufficiently understand the danger that, when these arrangements are poorly thought-through, they can give rise to a crippling deadlock or other dysfunction among the owners of an emerging business. Experienced counsel can help the managers of an emerging business evaluate the appropriate shareholder agreement provisions.

The following is a brief description of some of the more common types of governance and ownership arrangements which appear in shareholder agreements of emerging businesses:

- **Voting agreements** – These provisions often govern who will have the right to appoint directors, and who must vote in favor of those appointments. Sometimes voting agreements will bind particular shareholders to vote in favor of, or grant an irrevocable proxy to an other shareholder to vote for, a broad range of corporate decisions. Whether these types of arrangements are desirable, and how they should be engineered, will depend on the configuration, the relative power and business experience of the various shareholders.
- **Repurchase options; rights of first refusal** – An

emerging business has a clear and overarching interest in seeing that its shares stay in the hands of individuals and groups who are internally compatible and focused on similar goals. For this reason, such businesses will almost always restrict the transfer of shares by the existing shareholders to new shareholders. These restrictions can take many different forms. Often, the shareholder agreement will grant a right of first refusal to the company and/or the other shareholders, if a particular shareholder proposes to transfer shares to a person not previously associated with the emerging business. A shareholder agreement also will often grant the company the right to re-purchase shares held by shareholder employees upon termination of their employment, to avoid having a disgruntled ex-employee as a shareholder.

- **Preemptive rights** – Existing shareholders often have the right to purchase on a pro rata basis new shares that may be issued by the emerging business, to ensure that they are able to retain their ownership percentage in the company or simply participate in additional investment opportunities with the company.
- **Drag-along rights** – Under this type of provision, upon the decision by some specified percentage of the shareholders to sell the emerging business, all of the other shareholders are obligated to cooperate in the sale. Often, the shareholders proposing the sale already have enough votes to approve the sale, and the effect of this provision is to divest other shareholders of their statutory rights to dissent from the sale. These provisions are often controversial, and several legal issues around their enforceability remain unresolved by the courts.
- **Come-along rights** – Investors will often insist that if a controlling shareholder or group of shareholders wishes to sell its shares to an outsider, the investor will have the right to participate in the sale (and crowd out a portion of the controlling shareholders' shares) in the same proportion as the percentage of shares that he or she owns. Often, this type of provision is used as a device for keeping a manager focused on the business, when the investor may have invested

largely on the basis of the manager's commitment to the business.

Legal Considerations

In addition to the challenges that an emerging business faces in finding willing investors, federal and state securities laws impose restrictions on how a private offering of securities may be conducted and who may participate in such an offering. In essence, the federal Securities Act of 1933 (Securities Act) and analogous state laws require any offering of securities to be registered with the Securities and Exchange Commission (SEC), unless the offering meets the requirements for one of several exemptions from those registration requirements. In practice, it is necessary for an emerging business to offer its securities under one of the exemptions from registration, because of the expense and trouble involved in conducting a registration. The most popular and arguably the most useful exemption is the safe-harbor exemption for private offerings that meet the requirements of Rule 506 of Regulation D under the Securities Act. In layman's terms, Rule 506 limits issuers to offering securities to carefully targeted "accredited investors" and other sophisticated investors, who are fully informed of all material information about the investment and who agree to take "restricted securities" in the issuer.

The first technical requirement of Regulation D is that the issuer must refrain from making a "general solicitation." This means that the issuer must limit its solicitation to individual investors or small groups of investors who the issuer reasonably believes to be sophisticated in evaluating privately placed securities. Mass-mailings, newspaper ads, television or radio spots and public seminars clearly violate this requirement and should be avoided under all circumstances. Internet listings will be considered a general solicitation unless the site which lists the investment opportunity incorporates certain procedures to query the investors' status and ensure that only qualified investors can access offering materials. A general posting on a Web site without access restrictions is considered a general solicitation.

Another technical requirement of Regulation D requires the offering to be made only to "accredited investors" or other sophisticated investors who have the knowledge and experience to understand the merits and risks of the investment. We strongly suggest that issuers limit their seed

The Dilution Conundrum

Many founders of an emerging business and early-stage investors focus a great deal of attention and expectation on the percentage of their interest in the company. While percentage ownership is a useful tool for negotiating the terms of a seed capital investment, both management and investors should recognize that the percentage size of their interest is usually a temporary arrangement. In fact, it is normal and healthy for most emerging businesses to need more capital in the future. The key question is: At what price?

When managers and investors of an emerging business discuss the subject of dilution, they sometimes confuse two related but very different concepts: percentage dilution and economic dilution. Percentage dilution is often meaningless, but economic dilution is crucial. The reason is simple. A growing business that is creating value for itself is able to sell its shares at a higher common share equivalent price than in previous financing rounds. Under this scenario, new investors buy shares at a higher price than existing investors. Existing investors surely suffer percentage dilution, but they also enjoy economic accretion. This is generally a good thing for existing investors, because although their percentage interest in the emerging business goes down, the value of their economic interest in the company goes up.

By contrast, an emerging business that is struggling to create value for itself will only be able to sell its shares, if

at all, at a lower common share equivalent price than in previous rounds. Existing investors will suffer both percentage dilution and economic dilution, sometimes in spades. Depending on the severity of the dilution, a new investment round at a lower common share equivalent price may be referred-to as a “down round” or, in an extreme case, a “washout round.”

Of course, many early investors will wish to maintain a constant percentage interest in a growing company and enjoy economic accretion. While this is certainly desirable, it is not very realistic in the context of an emerging business. Realistically, an early-stage investor should only expect to avoid percentage dilution by providing additional capital as needed by the company. When this type of arrangement is provided-for contractually in investment or charter documents, it is referred to as a “pay-to-play” provision. Occasionally, a prospective investor will try to defy the realities of emerging business finance and seek a contractual provision guaranteeing him or her a percentage interest in the company, even after others have put additional capital into the company. While this idea sounds clever, it almost never works, since new investors will never agree to invest in the face of such an arrangement. The result is a pointed demand to drop such a right. For an emerging business with short-term liquidity needs, negotiating a waiver of such a provision can lose valuable time.

capital offerings to persons who fall within the “accredited investor” definition, since this classification gives the issuer substantially greater leeway in the preparation of disclosure materials. An investor will be considered an “accredited investor” if, among other alternative criteria, the investor has an annual income of \$200,000 individually, or \$300,000 together with a spouse; if the investor has a net worth of

\$1 million; or if the investor is an entity with \$5 million in assets.⁷

If the offering is limited to accredited investors, disclosure need not follow any particular format, although it should be sufficient to inform investors of all material facts about the investment.⁸ This disclosure is usually embodied in a private placement memorandum or other written materials.

⁷As of the date of publication of this book, the SEC has proposed changes to the “accredited investor” definition. It is unclear whether, and in what form, these changes may be adopted.

⁸As Preliminary Note 1. to Regulation D makes clear, “The following rules relate to transactions exempt from the registration requirements of section 5 of the Securities Act of 1933 (the “Act”). Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers are reminded of their obligation to provide such further material information, if any, as may be necessary to make the information required under this regulation, in light of the circumstances under which it is furnished, not misleading.”

The contents of such a document will vary with the circumstances, and the dynamics of the document are beyond the scope of this book. It suffices to say that experienced securities counsel should prepare and/or edit such a document. If the document does not properly describe all material risks, then the investor will have the legal right to rescind the investment and receive his or her money back—obviously, a catastrophic situation for most any emerging business. In such situations, liability can also be imposed on officers, directors and other “control persons” for misstatements or omissions of material information.

If the offering includes any non-accredited investors, then the non-accredited investors must receive a private placement memorandum which contains a long list of specific disclosure items and financial statements and is in general much more fulsome than an accredited-only document. Under the relevant caselaw, the disclosure should be comparable to what would be provided in a public offering prospectus. This type of disclosure is much more time-consuming and expensive to prepare than disclosure for an offering to accredited investors only, and is ill-suited to a seed capital round.

If the emerging business has used an unlicensed finder in the process of conducting the offering, then disgruntled investors may similarly have the right to rescind the investment or seek to hold liable any “control persons” if the business has no available assets.

The Role of Counsel

Counsel typically plays a critical role in structuring and closing an offering of seed capital. If counsel is consulted early in the process, he or she can advise the manager of an emerging business about what its capital structure should look like, the type of investor that is most likely to be interested in participating in the offering, what type of investment instrument is most appropriate for the offering, how to structure negotiations with investors most efficiently and advantageously, how to make sure that the offering meets all of the requirements of the relevant legal exemptions and how to make appropriate disclosures to the investors. With the right planning, an offering of seed capital can help an emerging business move beyond the initial hurdles that it faces, to reach a point where it is a candidate for professional VC investors.

* * *

Venture Capital Financing

by Michael J. Drooff, Esq.

Once an emerging business has developed and commenced marketing a product, and if that product has the potential to achieve rapid growth in revenues and profits, the managers will often seek a professional venture capital (VC) investment in order to fuel that growth. VC funds are typically organized to infuse substantial amounts of capital into an emerging business with exciting growth prospects, to help manage that growth, and to position the business for an initial public offering or a sale at an advantageous value. According to the National Venture Capital Association, VC investments totaling \$30.5 billion were made in 2007 in 3,912 deals. In 2008, VC investments decreased by 8% to \$28.3 billion, in 3,808 deals.⁹ Although the 2008 investment figures represent a significant drop in this specialized market, given all of the turmoil throughout the markets in 2008, the relatively modest decline shows that VC investing continues to be a substantial segment of the capital markets.

But while a VC investment can benefit many types of emerging businesses, it may or may not be right for any particular business. For example, the demands that VC investors make on a business may be excessive or inappropriate for a business with good, but not explosive, growth prospects. Also, venture capitalists are typically very assertive about their opinions and rights, and may be quick to dismiss managers who they perceive as not focused on their goals. Managers of an emerging business should carefully consider their willingness and ability to work very closely with demanding venture capitalists.

Who Are the Venture Capitalists?

Unlike angel investors, venture capitalists typically manage money raised from others, chiefly institutional investors, like pension and hedge funds and high net worth individuals. As a result, venture capitalists take a much

more instrumental view of an investment in an emerging business. They typically aim to provide overall returns to their investors in the range of 30 to 50 percent annually and to return their capital to investors between five and 10 years after the inception of a fund. In order to offset the many investments that venture capitalists expect will ultimately fail or prove marginal despite their best efforts, they expect to realize very high returns from their investments that prove successful. Whether their manner is friendly or irascible, an emerging business should not expect venture capitalists to provide any gratuitous benefits or indulgences to an emerging business; venture capitalists are often heard to argue that their fiduciary duty to their investors requires them to seek every benefit to which they are practically or legally entitled.

On a personal level, venture capitalists come in several different stripes. Some still fit the profile of an individual with a strictly financial background. With the rise in prestige of the VC profession, many individuals have been attracted to the profession with a background in operations or law. Diversity is doubtless a positive influence on the profession. For an emerging business seeking a VC investment, however, this trend has made it more important to gather as much information as possible about the background and orientation of a venture capitalist who it seeks to approach, in order to enhance the chances for a productive discussion.

Approaching Venture Capitalists

Before making first contact with a venture capitalist, a manager of an emerging business should make sure he or she is making the right proposition to the investor. A venture capitalist will immediately assess the strength and track record of the management team, which should be fully identified and committed to the business. The venture capitalist will also want to review a well thought-out business plan, which shows how he

⁹ Source: the MoneyTree Report by Pricewaterhouse Coopers and the National Venture Capital Association based on data by Thomson Financial.

or she can achieve high returns in a liquidity event in a three to five year time horizon. The business plan should make clear how the emerging business already has and expects to exploit a highly profitable product or service in a way that other businesses will not be able to challenge or replicate. The business plan should provide a comprehensive vision of how the business will grow, and it should be specific enough to convince the venture capitalist that the plan is achievable. If the manager cannot present these elements, then he or she is well advised to defer contacting a venture capitalist. Venture capitalists are typically flooded with business plans, and a misstep could easily ruin his or her initial impression of the emerging business. First impressions with venture capitalists are crucial.

Venture capitalists are not difficult to find, but the type of introduction can often be important. Venture capitalists often react like other human beings to cold calls: their immediate reaction is “no.” A mutual acquaintance in the business community can often break the ice; sometimes a professional with some stature can convey the right impression. Angel investors with a well-known reputation can also provide an effective channel to approach venture capitalists.

Like other professionals, venture capitalists tend to specialize in particular areas. Because of the risk they run with a portfolio company, venture capitalists limit themselves to industry segments they believe they understand relatively well. Before approaching a particular venture capitalist, a manager should understand the background and orientation of the individual contacted and that of the VC firm. Armed with knowledge about a venture capitalist’s orientation, an astute manager will often be in a position to tailor his or her message to appeal to the venture capitalist’s experience and goals.

Managers of an emerging business should also try to understand where in the pecking order of the VC firm the individual contacted stands. A good investment opportunity promoted by a junior member of a VC firm frequently has less chance of being funded than a mediocre opportunity that comes to a more senior member. Venture capitalists are typically very sensitive

to hierarchy, both in the emerging business and in their firms as well.

Timing a VC Investment

Ideally, the managers of an emerging business should always look well into the future regarding the company’s needs for capital. The process of lining up a VC investment is often quite long—many months—and the consequences of running out of funds at a critical stage in the company’s development are often dire. In addition, some venture capitalists will, consciously or not, offer less attractive investment terms to an emerging business that they know has few alternatives and urgently needs funds. Management should work to close the VC investment well in advance of when the company’s funds are expected to be depleted.

The Due Diligence Process

The due diligence process that is followed by most venture capitalists incorporates a number of phases over the course of several months. After reading an appealing business plan, the venture capitalist will typically visit the emerging business to examine financial projections and capitalization figures, meet managers and employees, and attempt to test the products in some way. If he or she has a positive impression, the next step may be to talk to others in the industry or outside experts, to assess the prospects for successfully realizing the business plan. At the next stage, the venture capitalist will review key agreements involving the emerging business. If indications are positive, and if the emerging business is lucky, the venture capitalist may offer a term sheet representing its investment proposal.

After a term sheet has been agreed upon, the venture capitalist will typically involve its lawyers in the due diligence process. The lawyers will conduct a thorough review of the emerging business’ capital structure, corporate records, agreements, intellectual property rights, litigation risks, and any other relevant information. Items of particular interest to the venture capitalist are outstanding stock options to employees, protections for company intellectual property, loans and other transac-

tions from and to insiders, and blocking rights held by existing investors. This process will typically run for several weeks, while the lawyers also prepare investment documents. The fact that the legal due diligence process happens at the same time as document preparation is no accident; legal issues identified during due diligence will frequently influence how the documents are drafted. Due diligence issues will drive the representations and warranties that the company will be asked to make to the investors and the special contingencies and management arrangements that will be required.

The due diligence process will often uncover various housekeeping items that the emerging business, with its focus on product and distribution channel development, may have neglected. Often these issues are minor and can be resolved with a low-level effort. In other cases, however, the issues are more substantial and delay or significantly hinder a financing. For example, an early key employee may have been promised a slice of the company's equity which was never formalized, or an early contract with a supplier or customer may contain terms that are fundamentally objectionable to an investor. The founder may also have contractual arrangements with the company that were appropriate for a startup company but that the venture capitalists wish to terminate or put on an arms' length footing. While emerging businesses should at all times attempt to keep their affairs in order, this is not always possible. A wise manager of an emerging business should recognize that the process of moving toward a closing on an initial VC financing round is seldom quick and smooth, and plan to spend additional time and legal fees to resolve the problems that may arise during the due diligence process.

Once the legal due diligence and document preparation is complete, the venture capitalist will seek to "bring down" key investment assumptions. For example, the emerging business should expect to show its latest figures for product orders, payroll and cash balances shortly prior to closing, to allow the venture capitalist to avoid any surprises. Venture capitalists are acutely aware of the fact that, once the investment funds are wired to the emerging business at closing, their leverage with man-

agement decreases substantially, even though they may have the benefit of covenants and blocking rights in the investment documents.

Managers of an emerging business should respond to due diligence inquiries with a maximum degree of candor. Although venture capitalists want to hear that the emerging business is highly likely to be successful, they will almost always become aware of bad news if it exists. We believe that it is far better to be candid about bad news early in the due diligence process rather than later, since bad news which is surfaced late in the process can lead to a renegotiation of the deal or its abandonment. If a deal becomes unrealistic, it is better for the emerging business to move on to the next potential VC investor sooner rather than later. Also, most industries are small enough that individual reputations are well-known, and it hardly needs saying that venture capitalists will never invest in a company which is run by managers they do not trust.

Investment Terms

The terms under which a venture capital investor makes its investment are vitally important, even if they appear couched in technical "legalese." Many of the terms go directly to the heart of how the business will be managed, whether management can be dismissed and whether and how much of the proceeds of a sale of the emerging business the managers and existing investors will be entitled to keep. However, in most cases, the scope for negotiating investment terms is quite limited. If an emerging business has several venture capital firms interested in it, then it may be able to play one off against another to improve the terms of an offer. Outside of that type of situation, the emerging business may only have the power to nibble around the edges of the terms offered. Perhaps the most important tool that managers of an emerging business have to negotiate investment terms is a spreadsheet showing the pro forma distribution of proceeds after a potential sale of the company at several price levels. If the managers can show the venture capitalist that the managers have little practical economic reward except in the case of a runaway success of the company, they may be able to argue

that the venture capitalist should scale back some of its economic rights.

Investment terms offered by venture capitalists for investments in similar companies may change substantially over time, depending on the perceived state of the market for private equity. Factors that play into the market include the overall supply of private equity funds, conditions in the initial public offering and mergers and acquisitions markets, activity in the emerging business sector and other factors. Also, the proximity of the emerging business to another well-known and very lucrative deal can exert a strong influence over investment terms. For example, the acquisition of YouTube by Google in November 2006 at a total price of \$1.2 billion created astronomical returns to investors in that company and had a discernible effect on VC investing in several related fields.

Given the unique characteristics of many emerging businesses and the idiosyncratic nature of the market for private equity, the author has frequently argued that the concept of applying “market” terms to an emerging business is often more than a little fallacious. Every emerging business presents a very distinct investment proposition, depending on the quality of the management team, the products to be sold, the industry segment, and the prospects for ultimate success. After all, an emerging business has little or no track record in its operations, novel products, limited resources and unknowable prospects. When a venture capitalist argues that a given set of terms reflects market terms, it is often shorthand for what he or she expects to be able to impose under the circumstances, rather than a normative statement about what might be fair under the circumstances.

A serious discussion of investment terms and the many permutations that venture capitalists can imagine, is beyond the scope of this book. Instead, this book will examine a few of the overarching themes that investment terms typically follow in a venture capital round. It suffices to say that investment terms should be as much a function of an emerging business’ characteristics and needs as they are of the venture capitalist’s style and goals.

An Investment Model Example

The emerging business determines that it needs to raise \$5 million to make necessary capital expenditures and provide sufficient working capital for the expansion of its business. Based on credible projections, it believes that it may be in a position to sell itself after four years for \$40 million. A venture capitalist that demands an annual rate of return of 40 percent will want to see his or her investment grow to \$19.2 million at the end of that period. Thus, the venture capitalist will ask for approximately 50 percent of the common share equivalents for his or her investment.

A discussion about investment terms usually begins with a consideration of how much capital the emerging business needs in order to propel the business to the next level of success. Once this figure has been determined, the venture capitalist will apply its expected rate of return over a period of years until an expected liquidity event and arrive at a targeted value of its stake in the company. The rate of return will frequently exceed 30 or 40 percent, to compensate the venture capitalist for the risk borne during the life of the investment. The percentage interest in the company upon making the investment will usually correspond with the percentage interest in the company as of the time of the expected liquidity event necessary to yield the desired rate of return.

Depending on his or her objectives, the venture capitalist may also ask for a current rate of interest on the investment, both to generate immediate return on his or her investment and as a means of putting pressure on management to achieve projections or encourage an eventual sale of the company. This current rate of interest usually takes the form of a preferred dividend rate. That is, the board of the emerging business will have an obligation to pay 5-10% of the amount invested each year, payable before any dividends can be paid on common stock, if the business has any profits available. Many venture capitalists also charge significant closing and other fees, including the fees of its lawyers. As a result, the emerging business should plan to have somewhat less in net

proceeds from the offering than its own expenses would suggest.

Venture capitalists almost always take a type of stock known as preferred stock. In fact, preferred stock is a defining characteristic of venture capitalists. Debt instruments are generally the tools of mezzanine investors, who generally invest in different types of companies than venture capitalists. Occasionally, an investor calling him- or herself a venture capitalist will offer to invest through a debt instrument, but such an investment should be approached with caution by the emerging business. While debt capital will pay the bills as well as equity capital, it is usually unrealistic for an emerging company to be expected to service debt in the amounts that are proposed as investment capital. The IRS may also challenge the deductibility for tax purposes of the debt for an investment that clearly has the risk characteristics of equity. Outside of bridge loan situations, debt instruments generally should be avoided by emerging businesses.

Preferred stock derives its name from the priority return (also known as a preference) that its holders have to the proceeds in any liquidity event, particularly a sale of the company. Preferred stock holders will typically be entitled to receive a return of the amount invested by them increased by the specified percentage dividend rate, before common stock holders are entitled to receive any of the proceeds. Preferred stock is almost invariably bundled with some other instrument or right which entitles the venture capitalist to participate in the upside potential of the sale proceeds. For example, the preferred stock may be convertible into common stock at a specified price, or the preferred stock may be automatically entitled to share in the proceeds otherwise available to the common stock holders without the necessity of conversion.¹⁰ Venture capitalists will often ask for common stock warrants in lieu of or in addition to any such conversion privilege, to further enhance their potential return. If the proceeds of a sale of an emerging business are large in relation to the capital previously invested, then the common stock will

usually be entitled to a larger distribution than preferred stock, since common stock distributions are not (by definition) capped at any pre-determined amount the way that preferred stock is.

The rationale for venture capitalists using preferred stock is that they typically buy their shares at a higher cash price than prior investors and founders, who may have received their shares for services. This higher buy-in price is based on the potential that the company will create that amount of value in its shares with the benefit of the investment funds. Consistent with this logic, the venture capital investor will ask for the liquidation preference as protection for his investment in the event that the emerging business does not create the expected value.

Depending on perceived conditions in the market for private equity, venture capitalists may propose to invest in a series of preferred stock that is entitled to a liquidation preference that is equal to a multiple of the amount invested. Thus, a “2X” preferred stock would be entitled to receive a liquidation preference equal to twice the amount invested. During the dark days of 2001 following the bursting of the tech bubble and the associated downturn in the private equity market, 2X and even 3X transactions were common and were defended by venture capitalists as “market.” Experience so far during the 2008/2009 downturn suggests that demands by VC investors for these multiple liquidation preferences are generally not returning. Whether or not such multiple liquidation preferences are representative of the existing market, they were and are highly draconian to other investors in an emerging business. Some respected members of the venture capital community have pointedly rejected the usefulness of these multiple preferences.

When considering an investment proposal that includes a multiple liquidation preference, the managers of an emerging business should carefully consider their fiduciary duties.¹¹ The large liquidation preference can result in majority voting control of the business passing to a new

¹⁰ Preferred stock that is entitled to a preferred return plus a share of the residual proceeds available to the common stock holders is known as “double-dip” preferred.

¹¹ Fiduciary duties which officers and directors have to their corporation under various states’ laws include the duty of loyalty to the corporation, the duty of care in performing their job, and the duty to refrain from self-interested transactions with the corporation. Other fiduciary duties apply in the context of a change of control.

set of investors. Whether or not voting control passes to a new group, a multiple liquidation preference greatly increases the dilution to existing investors and places them behind a large preference layer upon liquidation. There are instances in which the emerging business literally has no alternative if it wishes to stay in business, and this is perhaps the only viable justification for accepting these terms, at least when viewed through the lens of a director's fiduciary duties to existing shareholders. Before agreeing to such investment terms, however, a prudent manager of an emerging business should carefully canvass the market for private equity and make sure that his or her search is reflected in minutes of directors' meetings and other corporate proceedings, in case the decision is later challenged on fiduciary grounds.

Also, before agreeing to investment terms that include a multiple liquidation preference, the prudent manager of an emerging business should open up the investment round to participation by existing shareholders on substantially the same terms. Venture capital investors are often open to allowing co-investments by a limited number of existing investors. Making such an offer to existing shareholders presents a no-lose proposition, so long as it does not slow down an investment round that is urgently needed. If the existing investors accept the offer, they can serve as a useful counterbalance to the venture capitalist. If they decline, the emerging business can use that fact to deflect any potential criticism. Existing shareholders who choose not to participate in the round will have a much more difficult time asserting a breach of fiduciary duty by the directors.

Before agreeing to investment terms that include a multiple liquidation preference, management of an emerging business should prepare and review a spreadsheet analysis of the distribution of proceeds from a sale of the company at various foreseeable price points. This "cascade" of the proceeds through the various levels of preference and finally to the holders of common stock and common stock equivalents, will give management a stark reminder of what level of value will need to be created in order to produce a return for different investor groups. In addition to the practical guidance that such an exercise will give to management in making its decision,

the analysis may also prove useful in the event of litigation, showing that the board was fully informed about the consequences of its decision to take the financing on the terms demanded by the venture capitalist.

Sometimes investors in an emerging business will offer to make their investment in the form of a "bridge loan." Unfortunately, the term has come to be used in very different circumstances. In its truest sense, a bridge loan represents a short-term loan to bridge a liquidity gap which the emerging business is expected to experience prior to a pending equity financing. Sometimes the conversion price is fixed at the time the loan is extended; sometimes it is agreed to be the investment price which is negotiated as part of that equity financing, whatever that may be. Sometimes the loan is collateralized; sometimes it is unsecured.

The problems arise with bridge loans when the next equity financing does not materialize as expected, and the loan goes into default. This situation happens more often than most businesspeople like to admit, given the quirky nature of the market for venture capital. In almost all cases, the emerging business does not have the funds to repay the loan. This state of affairs is almost as difficult for the lender as it is for the emerging business. The lender has the right to force a liquidation of the emerging business, but this only rarely yields any substantial recovery to the lender. For the emerging business, it leaves the company subject to the whim of the lender, who has the power to destroy all of the (often rather tenuous) value which it has labored to create. The debt, if it is beyond its nominal servicing or payment terms, may cause the emerging business to become legally insolvent, whether or not it is insolvent in a practical sense. Unfortunately, legal insolvency can create some very difficult problems for the directors of an emerging business. Under relevant caselaw, it may cause the directors' legal duties to shift away from the shareholders and enhancing their value, toward creditors and protecting their positions. Under certain circumstances, this shift in fiduciary duties may accelerate the time when an emerging business must cease operations, at which point shareholder value is usually wiped-out.

Blocking Rights

In order to protect their preferred stock rights and to impose controls on management of the emerging business, venture capitalists will often insist on a set of “blocking” rights. That is, the charter and shareholder agreement provisions will include a list of various items, the adoption of which requires the venture capitalist’s consent. These blocking rights will depend on the venture capitalist’s style and the emerging business’ characteristics and may include the right to block management compensation above specified levels, the payment of dividends, transactions with insiders, and extraordinary transactions, such as acquisitions and mergers. Often, venture capitalists will ask for the right to take an enhanced role in management in the event of negative operating results, such as additional board seats and the power to veto specific management decisions. Although these blocking rights may seem onerous to management of an emerging business, they are almost always a part of taking a VC investment. Management should go into these arrangements knowing that they can and sometimes will be used to block transactions that may be perceived as benefiting other groups of shareholders, if they are not perceived as beneficial by the venture capitalist. The decision to accept these terms along with the other investment terms should be made in a manner and through a process designed to withstand scrutiny under fiduciary duty standards which apply to the emerging business’s board.

The most practical solution to this dilemma is to avoid it in the first place. The emerging business should acknowledge the risks of betting its future on a quick equity round and, in most cases, try to convince the investor that an investment which has the effective characteristics of equity should be treated like equity. The lender should remember that an emerging business is seldom in a posi-

tion to service a real loan, and that gamesmanship over whether a loan can be repaid often distracts management from the vital business of growing a company and creating shareholder value.

Doing Business under the Tutelage of Venture Capitalists

Many entrepreneurial managers of an emerging business find that operating under the control of venture capital investors requires a substantial adjustment to their management style. Venture capitalists expect to be informed of major (and often minor) business decisions in advance, and they expect that their decisions and advice will be deferred-to. This will often be the case even if the VC funds’ representative may be a newly minted MBA and the manager a veteran with many years’ experience in the industry. The wise manager of an emerging business will put aside any exasperation he or she may have with the venture capitalist, since he or she is typically bound to the venture capitalist under very tight legal provisions in the investment documents.

The managers of an emerging business with a VC investment should expect to spend a great deal of time preparing and negotiating budgets with venture capitalists. After many of the follies in the private company sector of the 1990s,¹² venture capitalists now take a very hard look at virtually all significant expenditures by the companies in which they hold investments. Emerging businesses should be especially reluctant to propose large advertising budgets, large cash salaries to employees and luxurious office facilities or amenities.

In many cases, venture capitalists will make their investments in more than one tranche, in order to enhance their control and mitigate their risk. For instance, the amount needed to see the emerging business through the first nine or 12 months may be funded at closing, with additional amounts contingent on

¹²In one case within the knowledge of the author, an emerging business (which was not a firm client) spent tens of thousands of dollars buying and modifying a “Whack-a-Mole” arcade game so that company employees could hit with a mallet the likeness of their managers for entertainment. The company is no longer in business.

reaching specified milestones, such as product launches, revenue targets or key contract signings. The emerging business which is presented with such a proposal during the initial negotiations over a term sheet, should consider the proposal very carefully and make sure that the milestones are clear and understandable and correspond with major junctures in the business plan.

Sarbanes-Oxley and Internal Controls

Since the goal of both the founders of an emerging business and its venture capital and other investors is to either sell the business to a larger company or go public, management should think proactively about how to structure the business' affairs to facilitate such an event. In either case, management is wise to establish effective internal financial controls. Some of the most important mandates of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) concern the establishment, administration and review of internal financial controls at public companies. If the emerging business believes that a logical exit strategy consists of a sale to a public company, then it should put in place internal controls that a public company will be comfortable stepping into. In addition, the Form 8-K rules which apply to public companies require the filing of pro forma and other financial statements for newly acquired businesses deemed to be material in size, a short time after the closing of the acquisition. In such a case, the absence of internal controls could delay or effectively prevent a sale to a public company. Similarly, to the extent that an emerging business' exit strategy includes an initial public offering, the internal control requirements will apply to the three-years of audited financial statements which must be included in the IPO prospectus.

Key to the establishment of effective internal controls is the formation of a functioning audit committee comprised of members with auditing or other financial reporting experience. Once formed, the audit committee can help management develop and monitor practices and policies on such topics as revenue recognition, capitalizing versus expensing various outflows, the appropriateness of reserves for various contingencies and the hiring and firing of auditors. While the cost in money and management time of conducting an effective program is usually considerable, it is in many cases part of the cost of doing business today. Also, venture capital investors often find that such a program promotes their own goal of professionalizing management of the emerging company.

Exit Strategies and Realities

Venture capitalists will seldom invest in an emerging business without a viable exit strategy, which is usually a sale to another company or occasionally an initial public offering.¹³ Venture capital funds, like other investment funds, feel a strong need to show a tangible return for their investors. Most venture capitalists will plan to exit an investment in an emerging business in three to five years. Because no organized market exists to buy the shares of private companies, and because securities law restrictions generally prohibit the resale of privately placed securities unless a specific exemption is available under the securities laws,¹⁴ the venture capitalist's exit strategy is typically very pointed with respect to the emerging business. That is, the venture capitalist will ask for rights under the charter and/or the stockholder agreement to either cause the company to redeem his or her shares after a specified period at an agreed-upon

¹³ Viewed in a historical context, the large number of early-stage and mid-stage companies which were able to go public in the late 1990s must be considered an aberration. Although many of these companies' stock prices rose dramatically in the immediate aftermath of their IPO, the longer-term performance of many of those stocks has been disappointing. After various regulatory investigations and private litigation over IPO practices during that period, it is now clear that much of the investor demand that drove many "hot" IPOs was artificially induced by questionable analyst reports, broker manipulation and day-trader exuberance. The author is of the view that the various factors that fueled the IPO boom of the late 1990s are unlikely ever to recur, at least to the same degree, due to various regulatory changes and other reforms.

¹⁴ Under SEC Rule 144, privately-placed securities may be freely resold without legal restrictions after a one-year holding period. However, since the venture capital investor will typically qualify as an "affiliate" for securities law purposes, it may have an independent duty to register any resale of securities, even after the Rule 144 holding period has expired.

Divergent Interests Of Venture Capitalists

Management of an emerging business should always bear in mind that the paramount goal of any venture capitalist is to maximize the return to investors in his or her fund. While this goal seems obvious, in practice it can sometimes lead to results that diverge from the interests of the emerging business, at least from the perspective of management and other investors and constituents of the emerging business. Recall that venture capitalists almost always insist on using a preferred stock with a liquidation preference as the instrument for their investment. Some of the possible divergences include the following scenarios:

- The venture capitalist may prefer to take a relatively safe but low-priced deal over the possibility of a much more lucrative but riskier deal, if he or she is assured of getting out whole by recovering the amount invested, especially if that amount is enhanced with a multiple liquidation preference.
- The venture capitalist may prefer to sell the company earlier than other investors, in order to realize a profit and give investors in his or her fund concrete good news about the fund.
- The venture capitalist may, consciously or not, reward managers who look after the venture capitalist's particular interests and punish those whose outlook may be broader but not as favorable to the particular interests of the venture capitalist.
- The venture capitalist will often cause the company to use legal counsel whose loyalties and professional duties run in favor of the venture capitalist rather than the company as a whole.

None of this is to suggest that venture capitalists are unethical business people. What should be clear to the savvy manager, though, is that the VC process has a very definite and very rigorous logic, which sometimes runs up against the interests of other investors and other constituents.

price, or to compel the company to sell itself under certain circumstances. Often, this type of arrangement is contained in a stockholder agreement, under the provisions of which the VC investors have the right to cause other parties to the shareholder agreement to sell their shares to a third party along with the VC investors. This type of arrangement is known as a "drag-along." The venture capitalist's goal is often not to exercise these rights, since the emerging business might not have ready access to sufficient cash and might not be able to sell itself at a time preferable to the venture capitalist, but instead to motivate the managers of the emerging business to be on the lookout for potential sale transactions. These liquidation provisions should be negotiated with extreme caution by management because they so directly affect the ownership and investment return of all other investors.

The Role of Counsel

While VC investment terms have undergone a degree of standardization over the last two decades, it is still essential for an emerging business to retain experienced counsel to guide it through the many legal and business issues involved in a venture capital investment. Counsel can help an emerging business position itself for such an investment by cleaning up problems in charter documents and shareholder agreements, negotiating the investment terms that may be negotiable, obtaining approval of existing shareholders to the VC investment, preparing disclosure documents for the investment and closing the investment in an efficient and timely manner. Experienced counsel can also provide valuable advice to the manager of an emerging business on how some issues with the investment terms are likely to play out over time and impact the parties' long-term interests.

* * *

Strategic Investments

by Alexander H. Pyle, Esq.

Many emerging businesses may have established relationships with potential investors without being aware of it. Sometimes the companies with which an emerging business is building commercial relationships, perhaps as a licensee, supplier or service provider, also have an interest in making “strategic investments” in complementary businesses. These more established companies could be particularly quick to grasp the strength of an emerging business’ strategy or technology and why the business could be an attractive investment. Strategic investors also offer an emerging business more than money. They can help an emerging business achieve its business and technical objectives by providing deep industry knowledge and by identifying known obstacles and overcrowded markets. Sometimes this assistance comes as part of a formal commercial relationship with the emerging business, while in other cases it may consist of informal counseling and referrals. An investment by an established industry player can also serve as an important symbol of recognition for the emerging business that allows it to boost its visibility in the marketplace.

However, strategic investments can entail a multitude of risks. In addition to all the risks associated with a traditional VC or seed financing, there is an additional dimension of risks created by the strategic aspects of the investment. Because of the multifaceted relationship that a strategic investment can create, managers of an emerging business should consider carefully how a relationship with a strategic investor would impact the emerging business. For example, being linked for the long haul to a particular industry player could make it more difficult to form commercial relationships with others in the market. It is also important to weigh the risks arising from giving a potential future competitor access to confidential information and voting rights.

What is a Strategic Investor?

The term “strategic investor” refers to a company that has a primary business of something other than investing, but invests, from time to time, in other companies

A Strategic Investment Example

A manufacturer of men’s razors might make a strategic investment in a maker of shaving cream or aftershave, but would probably not invest in another razor maker unless it served a different niche of the market, such as razors for women. Strategic investors often seek to capitalize on business synergies by entering into a commercial agreement with the emerging business in which they have invested. The nature of the commercial relationship varies from case to case, but a strategic investor often views the commercial aspects of the relationship as being at least as important as the financial aspects.

within its own market or in complementary markets. Strategic investors typically seek out companies that offer synergies with their own offerings but are not actually competitive at the current time.

Strategic investors come in many forms, sizes and levels of sophistication. Some are well-established semi-autonomous funds with their own management teams made up of former venture capitalists or investment bankers. These funds may have investment authority independent of their parent organization’s corporate decision-making processes, and so may resemble a traditional VC fund that happens to specialize in a particular industry segment. Intel Capital, for example, reports that it has invested more than \$9 billion in more than 1,000 companies, a record that only the largest venture capital firms can match. At the other end of the spectrum, some strategic investors may be essentially novice investors. Such investors may lack a formal process for evaluating a new investment or making decisions regarding existing ones. They can be more flexible than established strategic investors, making decisions on an ad hoc basis, with input from a CEO or CFO who often has limited experience in evaluating investment opportunities. It goes without saying that the structure and sophistication of a strategic investor will color its relationship with an emerging business both before and after the investment occurs. An emerging business would be well-advised to try to evaluate at an early stage the individuals or groups

that will be making decisions on behalf of a strategic investor, and try to divine what it will be like to work with these people as the emerging company develops.

Identifying Strategic Investors

There are several ways that an emerging business may establish a connection with a strategic investor. In some cases, the opportunity for a strategic investment may arise organically as an outgrowth of an emerging business' ordinary business development activities. In these cases, the investment may be seen as a way of cementing a relationship that was already under discussion. In other cases, managers of an emerging business may target industry participants as likely or desirable investors because they are potential future customers or collaborators. Once a major company has made an investment, it should be easier for the emerging business to gain entrée into the appropriate commercial departments of that company. Finally, a more traditional investor, such as a VC firm, may bring in a strategic investor to be part of an investor group. Traditional investors may view the involvement of a strategic investor as a valuable due diligence resource that can validate an emerging business's technology and market assumptions. In any case, managers of an emerging business may not be able to anticipate when or where a connection with a strategic investor may develop, so they should be prepared to evaluate and respond to opportunities as they arise.

A strategic investment relationship may also develop when a parent company spins off a majority stake in a former subsidiary or division to a group of investors. A parent company may spin off a business unit for a variety of reasons, such as a desire to spread the risk of an unproven technology or business model, or to create a more entrepreneurial environment for managers. In such a case, the strategic investment may be all or partly in the form of existing technology, contracts or relationships, rather than pure cash. Although such a structure begins with the parent company reducing its ownership stake in the emerging business, rather than making a new investment, the end result may be functionally the same as would arise from funding a new emerging business.

Regardless of how an emerging business is first introduced to a potential strategic investor, it is particularly important for the business to perform its own due diligence on the investor at an early stage in discussions. Management should find out as much as possible about the investor's past investment experience and what elements of the emerging business might be of particular interest to the investor. A company may make a strategic investment for many reasons but, in the author's experience, rarely is financial return on investment the primary factor. A strong financial story is usually necessary but not sufficient to interest a strategic investor. A strategic investor may view the emerging business as a way to counter a competitive threat, to solve an existing business problem, or to develop new markets. In some cases, a strategic investment can be a prelude to a full acquisition of the emerging business. In approaching a strategic investor, managers of an emerging business should prepare a tailored presentation that addresses not only the emerging business' growth prospects, but also the strategic fit for the particular investor.

It is also important for an emerging business to be selective about accepting a strategic investment. While an emerging business may have more than a dozen traditional investors, including angels and VC firms, it will probably never have more than one or two strategic investors. Accepting a strategic investment from one company may foreclose other strategic investments in the future, and could even affect other companies' willingness to enter into significant commercial transactions if the emerging business ends up being viewed as too closely allied with a particular company. For the emerging business too, a strategic investment is about more than just money.

Investment Terms

Just as the structure and organization of strategic investors can vary significantly, the terms under which they invest are also not uniform. As is often the case, if a strategic investor is participating in a round of financing that also includes VC investors, the strategic investor is unlikely to lead the round, leaving negotiations about valuation and investment terms to the professional

investors. Strategic investors often prefer to invest alongside traditional VC investors because they then have outside validation for the terms of their investments. A strategic investor will expect to receive the same rights and privileges as the other investors, even if the strategic investor is also entering into a commercial arrangement with the emerging business. As a result, when a strategic investment is part of a larger VC financing, the terms of the strategic investment generally mirror the terms of the overall VC round.

When a strategic investor invests independently, and not as part of a group, an emerging business may find that the investor is less demanding on financial terms than a VC firm would be. There are several reasons for this difference. One is that smaller strategic investors may be less sophisticated about company valuation metrics and deal terms. As a result, they may be more willing to consider the company's proposed deal terms, instead of dictating the terms themselves. Another reason is that a strategic investor typically has other reasons for wishing to pursue the investment – the commercial relationship that will accompany the investment. If the commercial relationship is attractive or important enough, the strategic investor may be less inclined to haggle over the investment terms. On the other hand, managers of an emerging business should be cautious about allowing an attractive set of investment terms to blind them to the shortcomings of a commercial deal, or vice versa. Finally, strategic investors may not be subject to the same pressures from their own investors as VC firms are. While VC firms often have a goal of providing their investors with a 30-50 percent return, and must return capital to their investors within five to 10 years, a strategic investor usually has only one investor to whom it must answer. Companies usually do not set out to make strategic investments simply for the sake of financial returns. Although companies hope that their strategic investments make money, they are usually more focused on the strategic goal of creating relationships with emerging businesses.

Commercial Elements

In addition to the financial elements of a strategic investment, there is often a commercial element that makes the investment “strategic.” The nature of the commercial

Board of Directors Naming Rights

An emerging business should be particularly cautious about offering a strategic investor the right to name a member of its board of directors. At first blush, having an experienced executive with deep industry experience on the board may seem appealing. But an emerging business must be sensitive to the conflicting loyalties to which a director who is also an employee of the strategic investor may be subject. As a director, the individual has a fiduciary duty to act in the best interests of the company and its stockholders. But what if the emerging business is considering a change in direction that would put it in competition with the strategic investor (or allying itself more closely with the strategic investor's major competitor)? In such cases, it may not be prudent to rely on the director's undivided loyalty. Even if a strategic investor is only granted board observer rights or participates only on an advisory board, the same issue can arise. Experienced counsel can help draft an appropriate agreement that will allow the business to limit access to sensitive information or discussions.

relationship between an emerging business and a strategic investor can vary widely. In some cases, the commercial element may be the key element of the relationship between the companies, with the investment viewed as almost an afterthought. In other cases, the commercial element may take the form of an informal collaboration that may or may not evolve into a more substantial relationship in the future. Examples of commercial arrangements include the grant of exclusive distribution rights to the strategic investor, the licensing of key technology, or the granting of a right of first refusal on future transactions. Often the commercial arrangement provides not just cash but early stage revenue to an emerging business, which can be an important milestone for the business.

Even if a strategic investment does not include a formal commercial agreement, the strategic investor can become an important resource to the emerging business. Regardless of whether the strategic investor participates in formal board of directors or advisory board meetings, the investor will often be prepared to help an emerging business

with sales and marketing advice, technical know-how, and introductions to other industry participants. These resources can be extremely valuable to an emerging business working to establish itself in a new market. Sometimes the fact that a major industry player has made an investment in a company is enough to open doors for the company, because the investment can be viewed as a seal of approval, even if the strategic investor does not actively seek to promote the business.

Risks of a Strategic Investment

It is clear that a strategic investment offers a number of benefits to an emerging business beyond the financial investment. But an emerging business should not lose sight of the risks that attend such an investment.

VC firms often refuse to sign non-disclosure agreements when they begin discussions with an emerging business, arguing that they talk to too many companies to monitor how confidential information is handled, and that they should be trusted based on their reputations. However valid these arguments may be for a traditional VC firm, they do not apply to a strategic investor, especially if its investment and due diligence activities are not clearly segregated from its commercial decision-making processes. Once a strategic investor has completed its investment, particularly if it also has the right to designate a board member or observer, the strategic investor will continue to have access to significant information about the company's financial results, its product and marketing plans, and its technology that are not known to the general public. While a well-drafted set of investment documents will require all investors to maintain the confidentiality of the information they receive, and restrict their use of such information, these protections can be difficult to enforce. In practice, it is usually difficult to know or prove whether an investor has misused the sensitive information it has received. The best protection is for the company to have the right to limit the information it discloses to a strategic investor in the first place.

Another risk that arises from accepting a strategic investment results from the long-term nature of a strategic investment. Once a strategic investor has become a stockholder, it will usually continue to be a stockholder until a

liquidity event takes place. If the commercial relationship between the strategic investor and the emerging business sours for any reason, the company may be unable to wash its hands completely of the strategic investor because the investor will continue to be a stockholder. Once the commercial aspect of the relationship has terminated, the strategic investor may lose confidence in the company's business and become an obstacle to future transactions that require stockholder approval. It may be in both parties' interests to provide for the redemption or transfer of a strategic investor's shares if its commercial relationship with the company terminates for any reason.

An emerging business should also be mindful of the risk of appearing to be too closely allied with a particular industry participant. In some industries, this risk is negligible, but in others it may be very serious. If the company intends to enter into commercial relationships with a number of competing companies, having one of the companies as an investor may create the perception that the emerging business is biased in favor of that company. It is important to take the long view when considering accepting a strategic investment and evaluate whether the perceived alliance with the strategic investor could hinder the company's future plans.

Managers of an emerging business should bear in mind that investments are often not integral to a strategic investor's overall business. As a result, the strategic investor may perceive decisions about its investments to be low priority, resulting in long delays in obtaining consents or other stockholder actions. Many companies require multiple decision-makers to sign off on any action affecting a strategic investment, in the same manner that a purchase order or new contract would be approved. When contemplating accepting a strategic investment, an emerging business should consider whether a delayed action by a strategic investor could end up delaying a significant transaction.

Furthermore, there is a risk that the strategic investor will decide to stop making strategic investments in other businesses altogether, perhaps as a result of internal business factors that have nothing to do with the performance of the companies in which it has invested. Many

strategic investors made this decision in the wake of the Internet bubble burst in 2000. When a company shuts down its strategic investing activities, it may decide to sell its portfolio to a new investor, and an emerging business typically has little or no say in the identity of that new investor. The new investor, who may have purchased the strategic investment for pennies on the dollar, can have very different goals and motivations than those of the original strategic investor, or than those of the emerging business' other investors.

Finally, some strategic investors may utilize the leverage provided them by their investment in an effort to buy the emerging business at a cheap price. Like venture capitalists, strategic investors will often ask the emerging business for various "blocking rights," i.e. the right to approve or disapprove of various corporate actions. Unlike venture capitalists, though, strategic investors sometimes use these blocking rights in a way that appears irrational when considered in relation to the purpose of maximizing the value of its investment.

However, there may be another logic behind the move. For example, a strategic investor may use its blocking rights to prevent the emerging business from securing the capital necessary to expand, in an effort to drive the emerging business into a sale transaction with it on favorable terms. For this reason, management of the emerging business should carefully scrutinize the blocking rights requested by strategic investors.

The Role of Counsel

Experienced counsel can play an important role in advising an emerging business about a proposed strategic investment and any associated commercial relationship. As an initial matter, counsel can help evaluate the proposed investment and commercial terms to ensure that they are consistent with the company's other obligations and will not create undue obstacles to future transactions.

Counsel can also provide assistance in making sure that appropriate confidentiality obligations are in place, a concern that is usually more significant with a strategic investor than it would be with a venture capitalist or other private investor. As with other private placements

of securities, counsel should also assist with overseeing the due diligence process, prepare appropriate corporate consents, approvals and waivers, and negotiation of the terms of the investment documents. Working with seasoned counsel can help an emerging business develop the framework for a successful long-term relationship with a strategic investor.

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The “Cascade”: Distribution of the Proceeds of the Sale of a Company with Multiple Layers of Preferred Stock

A defining characteristic of preferred stock is that it is entitled to preferential payment upon a company’s liquidation. Charter provisions will specify the amount and the priority of these payments. Sometimes a company is liquidated as part of shutting its doors, and sometimes it is liquidated after a sale of the company’s assets to a buyer.

The following is an example of how the proceeds of the sale of a company’s assets are distributed, assuming a substantial purchase price. For illustrative purposes, taxes have not been taken into account in this example.

Assume that the company is a venture-backed business with several layers of preferred stock. Three years after its inception, the company is sold to a strategic acquirer for \$40 million (net of retained liabilities). At its inception, 80,000 shares of Common Stock were issued to founders of the company in return for promotional and development services.

At an early stage, 20,000 Series A Preferred shares were issued to a group of “angel” investors for an aggregate price of \$5 million, representing 20 percent of the company after the investment. The Series A Preferred stock carries a 1x liquidation preference and a “double-dip” participation feature.

Later, 100,000 Series B Preferred shares were issued to the same group of angel investors in a “down round” transaction for an aggregate price of \$5 million, representing 50 percent of the company after the investment. The Series B Preferred likewise carries a 1x liquidation preference and a participation feature.

Still later, 200,000 Series C Preferred shares were issued to a venture capital fund for an aggregate price of \$10 million, representing 50 percent of the company after the investment. The Series C Preferred carries a 2x liquidation preference and a participation feature.

Before the sale of the company, there are 400,000 common share equivalents, comprised of 80,000 shares of Common Stock, 20,000 shares of Series A Preferred, 100,000 shares of Series B Preferred and 200,000 shares of Series C Preferred. The \$40 million purchase price (disregarding taxes) must be split between these shares at four different levels in the company’s capital structure.

As a result of the preferred stock terms described above, the purchase price will be split as follows:

Type/Series of Stock	Priority	Aggregate Liquidation Preference	Balance Remaining After Payment of Preference
Series C Preferred	1	\$20 mm (\$10 mm x 2)	\$20 mm
Series B Preferred	2	\$5 mm	\$15 mm
Series A Preferred	3	\$5 mm	\$10 mm
Common	last	Not Applicable	Not Applicable

Under these facts, \$10 million remains available for distribution to holders of Common Stock and common stock equivalents. Taking into account the participation features of the Series A, B and C Preferred, this \$10 million would be distributed as follows:

Type/Series of Stock	Percentage Holding	Amount of Distributions
Common	20 percent (80,000/400,000 shs)	\$2 mm
Series A Preferred	5 percent (20,000/400,000 shs)	\$500 k
Series B Preferred	25 percent (100,000/400,000 shs)	\$2.5 mm
Series C Preferred	50 percent (200,000/400,000 shs)	\$5 mm
Total	100 percent	\$10 mm

As a result of these distributions, the investors in preferred stock show the following returns:

Type/Series of Stock	Amount Invested	Total Distributions
Series A Preferred	\$5 mm	\$5.5 mm
Series B Preferred	\$5 mm	\$7.5 mm
Series C Preferred	\$10 mm	\$25 mm
Total	\$20 mm	\$38 mm

Going Public

by Michael J. Drooff, Esq.

For many managers of an emerging business, the ultimate achievement is successfully taking their company public in an underwritten initial public offering (IPO). In an IPO, the emerging business sells its shares to public investors and typically lists its shares for trading on a recognized stock exchange or other trading system. An IPO is a way to raise large amounts of additional capital, and a public registration and listing makes it much easier for the company to conduct future offerings and acquisitions using the company's stock as consideration in the future. An IPO is sometimes viewed as a goal in its own right, as it confers status and credibility on the company and its managers, and often, though not necessarily, results in the enrichment of founders or managers.

Benefits, Burdens and Risks

In reality, going public carries substantial burdens and risks, in addition to rewards. An IPO may allow an emerging business to part company with VC investors, who may choose to sell into the offering or, more commonly, conduct a follow-on offering of their own months after the IPO. An IPO may also allow the company to realize liquidity for founders, managers and early-stage investors. Although the legal restrictions on sales of stock by insiders of a public company are complex, a public trading facility may allow such groups to cash-out at a much higher market price than the price at which they invested. However, an IPO is a very expensive process, both in terms of the direct expenses of the offering, but also in terms of the time, attention and expenditures required to prepare the company for an IPO. An IPO also subjects the managers of an emerging business to a high degree of liability, because the registration provisions of the Securities Act of 1933 (Securities Act) make

an issuer and its "control persons"¹⁵ strictly liable¹⁶ to public investors for material misstatements in the offering documents. Once a company is publicly traded, it falls under the many provisions enacted as the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley); some of these are discussed under "A Brief Summary of Public Company Obligations." Also, going public exposes the company to judgment by the equity markets, which can be a very fickle master.

A company that goes public is expected by the markets to continually enhance shareholder value. If an IPO happens in a time of high expectations, the newly public company may have difficulty meeting expectations. An IPO candidate which is celebrated by the markets and commands a high IPO price, may very easily lose the confidence of the markets by stumbling (or appearing to stumble) in the aftermath of an IPO. Moreover, smaller public companies that lose the confidence of the markets may find it very difficult to regain that confidence, as brokerage house analysts may stop covering a stock, and without analyst coverage a company's stock price on the market may languish for a long time.

A public company with a low market price exists in a kind of purgatory. It may have all of the burdens of a public listing with few of the benefits. Management may be subject to change, since the markets abound with opportunistic players with colorful names such as "bottom-fishers," "bust-up artists" and "green-mailers," among others. Shady brokerage houses may attempt to manipulate the stock price of the company in an effort to earn illegal profits for themselves, with negative repercussions for the company.¹⁷ The company is also subject to

¹⁵ The term "control person" is a recurring theme under the federal securities laws. While it is quite vague (and hence a valuable tool for plaintiffs and prosecutors), it is generally understood to include those individuals and entities that have the power (whether exercised or not) to influence the management and policies of the issuer. Control will be presumed for an issuer's executive officers, directors and shareholders owning greater than 5 percent of the issuer's stock.

¹⁶ Strict liability means that an investor suing the issuer does not need to prove that the omission or misstatement of the necessary disclosure involved fault on the part of the issuer. The investor only needs to prove that the statement at issue was false or misleading.

¹⁷ In the late 1990s, federal and state prosecutors established that several small brokerage houses were actually controlled by the Mafia and other criminal gangs.

being taken over by legitimate investment groups, which typically install their own slate of officers and directors in an attempt to turn around the company's fortunes. Although unsolicited tender offers are not common, takeover proposals that management of a public company cannot turn down without grave risk of incurring liability to shareholders, are quite common.

If the public company's market price drops very low for any appreciable period of time, it will be de-listed in accordance with each of the exchanges' rules. Since the delisting has the effect of limiting the liquidity of the company's stock, a further drop in the price of the stock typically accompanies de-listing. In such a situation, the de-listed public company has the worst of all worlds: a lack of liquidity in its stock, unfavorable regulatory action, and a continuation of public company reporting requirements. The Securities and Exchange Commission (SEC) does not allow operating companies which have been delisted or have otherwise fallen on hard times to shed their public filing obligations. That such a company may not have the funds to engage an auditor and file its Form 10-K annual report and proxy statements, is not considered by the SEC grounds for ceasing its public filings. In short, the consequences of a delisting are catastrophic, both in terms of lost shareholder value and the likelihood of investor lawsuits and regulatory action against management.

Planning for the IPO

To be a serious candidate for an IPO, an emerging business must have realistic prospects for substantial growth, either through an important position in a developing market or a significant innovation in a mature market. Besides growth prospects, the characteristics of a serious IPO candidate vary, depending on market conditions and the prevailing thinking among venture capitalists and underwriters. During the late-1990s, many very early stage companies with little revenues, but substan-

tial perceived prospects in a "hot" sector, were able to go public. Many of those IPOs were essentially driven by a marketplace that was not functioning properly, due to several factors unlikely to recur in the foreseeable future.¹⁸ It is not currently known what criteria underwriters will apply to IPO candidates in the IPO market which will develop after the 2008/2009 downturn. It is likely, however, that a successful IPO candidate in the future will have revenues in the \$50 million to \$100 million range, with at least a short history of profitability and strong projections for accelerating profitability. Also, mutual fund managers and other sophisticated market participants have in recent times shied away from IPOs that are smaller than approximately \$50 million, because a company with a smaller IPO generally has trouble attracting analyst coverage. Without purchases by mutual fund managers, an IPO is unlikely to succeed.

On a practical level, it is essential for an emerging business that is considering an IPO to have available at least three years of audited financial statements. If the business has not previously had the statements from the last three years audited, it may still be possible to have those statements audited retroactively, but only if the accounting records have been sufficiently well-kept. This requirement for three years of audited financial statements also applies to businesses the emerging business may have acquired prior to an IPO, so accounting practices should be an important issue in any acquisition activity conducted by an emerging business considering an eventual IPO.¹⁹

For accounting purposes, it is also important for an emerging business that is considering an IPO to think through whether its business consists of one, or more than one, business segment. That is, should the business be required to separately report the operating results of a line of business considered sufficiently distinct from other lines of business conducted within the same company? The analysis of this issue is typically quite com-

¹⁸ Some of the factors which contributed to the IPO boom of the late 1990s included huge inflows into the mutual fund industry, the emergence of speculative day trading by inexperienced individual investors, questionable practices by otherwise-legitimate investment banking houses which tended to artificially raise IPO prices, and the general expectation by public market participants that market prices would continue to follow long upward trends.

¹⁹ See Article 3 of SEC Regulation S-X, which applies to all IPO prospectuses.

Role of VCs in Going Public

The role of VC investors in taking an emerging business public is subject to debate in particular circumstances. VC investors can undoubtedly facilitate the process of going public, but the answer to the question of whose interests are best served by the IPO will depend on the circumstances. VC investors often promote the idea of an IPO as part of their strategy of liquidating their investment at a significant gain. Managers of an emerging business, however, should beware of the burdens and risks of going public before both their company and the market are ready. Emerging businesses should also be wary of VC investors' claims that the company should take a substantial additional investment from them in order to cover the large costs of going public. While going public is, in fact, a difficult and expensive undertaking, management should carefully review the post-funding capitalization of the company and assess whether a significant motivation of the VC investors is to enhance their share of the benefits of the IPO.

plex and hinges on such things as what other industry participants report; what are the key operating characteristics of the business or businesses; whether management for its own analytical purposes tends to break out separate operating results; and many other factors. The SEC accounting staff can be highly opinionated about segment reporting and often rejects segment determinations made by reputable auditing firms. Unfortunately, a determination that segment reporting is required when it was not previously done, can have a devastating effect on an IPO due to the time and expense involved in breaking out and restating operating results into the appropriate segments.

Selecting Underwriters

Once an emerging business has decided to go public, perhaps the most important decision is who to select as the underwriters. Many businesspeople are surprised by the variations in the quality of underwriters. For emerging businesses with the luxury of choice, it is preferable

to hire one or more of the “bulge bracket” investment banking houses that all businesspeople know. These large investment-banking houses bring to the task the expertise, mutual fund contacts and retail customer base necessary to complete large and complex offerings, as well as the professional discipline necessary to assure that liability and disclosure issues are appropriately addressed. In many cases, equally valuable are the smaller but more specialized and well-known investment banking firms. The next tier of investment banking firms consists of the well-known regional houses. At the bottom of the investment banking hierarchy is a substantial number of firms which should be viewed with skepticism. Some of these firms may employ questionable sales and trading practices, which ultimately hurt the issuer. While certain small, relatively unknown investment banking firms may be able to complete a public offering without resorting to questionable sales practices, and afterward may be able to adequately support the public market for the issuer's shares, the background of such firms should be carefully checked. Experienced counsel can assist greatly in accessing and interpreting the disciplinary records of underwriters.

Several underwriters which have historically been viewed as reputable came under investigation for their IPO practices during the late 1990s, when trading in the aftermarket of many IPOs produced very large price gains. As it later became clear, many of these price increases were driven in large part by unethical and, in several cases, clearly illegal, arrangements. One type of such arrangement involved underwriters who would allocate shares in what was perceived to be a “hot” IPO to investors who agreed to hold the shares off the market for a period of time. This type of arrangement had the effect of restricting the supply of shares on the market and artificially inflating the price. Another such arrangement involved underwriters who allocated shares to favored clients, such as mutual funds or important company executives, with an arrangement that other, less favored, investors would quickly buy the same shares from the favored client at a higher price. As alleged in several administrative and criminal cases, these arrangements were not disclosed to investors despite the fact

that they were intended to materially affect the market price of the company's stock. Under existing provisions of the Securities Act, these arrangements amounted to material omissions from the disclosures in the IPO prospectus, thereby leading to strict liability not only on the underwriters who perpetrated them, but also on the unsuspecting issuers. The discovery of many of these arrangements also made it clear that certain underwriters were not obtaining the best price available on the market for issuers conducting IPOs. Although it will always be difficult for an issuer to police the conduct of underwriters in its IPO to prevent abuses from happening, it behooves the issuer to carefully consider the disciplinary history of its underwriters and to carefully monitor the underwriters at the time of an IPO.

In an IPO, underwriters typically operate in a group, or "syndicate." One or more underwriters who are chosen by the company act as "lead underwriters" or "managers" of the syndicate. These lead underwriters will, almost always, enter into agreements with scores or even dozens of other, smaller firms with substantial client bases, to help sell the offering. Although there is typically a substantial amount of jockeying among firms for allocations of the stock, particularly if it is perceived as a "hot" issue, the company is rarely involved in these allocation decisions.

The process of underwriter selection should begin with a review of which underwriters are most active in a particular business' industry. Industry expertise is crucial, since it will allow the underwriter to better understand the business' operations, take advantage of credibility in the investor community to sell the IPO and provide research support for the stock markets after the IPO closes. The relative size and reputation of an underwriting firm are, of course, very important, because these factors tend to expose the IPO to a broader section of the investor community. However, industry expertise will often serve the emerging business better than sheer size over the long run. Industry experience by underwriters sometimes has disadvantages, however. For example, an underwriter, which is currently working with another large player in the same industry as the emerging business seeking to go public, may, consciously or unconsciously, favor the

larger player in its research reports and how it otherwise supports the IPO company. Prior to engaging an underwriter, the emerging business should make sure it understands what type of support it can expect from the underwriter in the future. Although these types of commitments are not a part of the engagement letter or underwriting agreement, they may provide a very important basis for evaluating several underwriter candidates.

Due Diligence and the Prospectus

The process of preparing a public offering begins in earnest with the start of due diligence and the drafting of the Form S-1 registration statement and prospectus. Because they bear significant liability in connection with a public offering, the underwriter and its counsel will conduct a due diligence effort that parallels the due diligence effort that the issuer and its counsel should conduct. Due diligence, which is often derided by businesspeople as excessively expensive and time-consuming, is the process by which the participants in an offering review the business operations, competitive position, third-party agreements, management compensation and financial statements of the issuer. Its purpose is to make sure that the characteristics of the business and its obligations and risks are adequately understood by all the participants in the IPO, in order to avoid the strict liability which arises from any misstatements in the prospectus under section 11 of the Securities Act.

The due diligence effort feeds logically into the drafting of the registration statement and prospectus, which must meet both specific and exhaustive disclosure requirements, and convey all of the risks and other information necessary to fairly apprise prospective investors of all material information concerning their investment in the emerging business. For these purposes, "material information" means all information that could, under all of the circumstances, significantly affect a decision to invest in the shares. Although certainly expensive and time-consuming, the due diligence and disclosure process are absolutely necessary to the overall IPO process. An incomplete or defective due diligence and disclosure process leaves open the risk that, once the offering is com-

plete, the issuer may be faced with a class action lawsuit by investors seeking to recover their money. Whether or not the class action results in the issuer paying damages to investors, the mere prospect of such a suit can lead the market to lose confidence in the issuer.

SEC Review and Marketing

Once the registration statement and prospectus are ready in preliminary form, the issuer files them with the SEC for review. Until this filing is made, the issuer is prohibited from offering its securities or even excessively touting its products in advertising campaigns. During the period leading up to the filing of the preliminary prospectus, managers of the emerging business should decline to grant interviews and should refrain from publicizing its operating results and particularly its projections or statements of future intent. If the SEC believes that the issuer is “jumping the gun” on its offering, it will impose a cooling-off period of several months in which it will not allow the IPO to proceed. Since timing is typically a large factor in the success or failure of an IPO, such a cooling-off period can have a very negative effect on an IPO.

With the filing of the preliminary prospectus, the issuer and the underwriters are free to begin pre-marketing the shares to the public. Typically, representatives of the issuer and the underwriters will launch a “road show” marketing effort, traveling to key money centers and making presentations to sophisticated investors and other customers of the underwriters. If the lead underwriters have not already done so, they will line up other underwriters to form the underwriting syndicate. Until the SEC clears the registration statement and prospectus, however, the issuer and underwriters are not allowed to consummate sales of the stock to investors.

The review and comment process with the SEC can be a source of frustration to management of the issuer. All IPO registration statements are reviewed in detail by the legal and accounting staff of the SEC, who will point out real and perceived disclosure deficiencies that must be addressed, either by making additional disclosures in an amended document or convincing the SEC staff that

such additional disclosures are not necessary. In recent times, due to the accounting scandals of the early 2000s, the SEC’s accounting staff has become very assertive in generating and pushing comments on financial disclosure. Issuers are usually well advised to accommodate these comments where possible, since alienating the SEC staff can become a significant liability for a public company.

At the end of the review and comment process, the SEC declares the registration statement and prospectus “effective” under the Securities Act. That is, the documents can then be used as the basis for consummating actual sales of shares to investors. Upon effectiveness, the offering is priced, an underwriting agreement is signed, and the members of the underwriting syndicate can consummate the previously arranged sales.

Pricing the IPO

Pricing an IPO is more art than science, with the typical price falling by design somewhere between \$15 and \$25. If necessary, the number of shares sold will be tailored to achieve a price in this range, which underwriters believe appeals to a large retail customer base. Since they have the job of selling the offering, the underwriters will have the greatest input into the pricing decision. Consciously or not, underwriters will often prefer to somewhat under-price a public offering. Skeptics have expressed the theory that some underwriters do so in order to please both sets of customers: the issuer who wants offering proceeds and the investor who wants a bargain-priced stock in his portfolio. Defenders of underwriters point out the benefits of pricing an offering conservatively in order to improve the stock’s price in the “aftermarket” following the offering. That argument may have merit, to the extent that the performance of a stock in the immediate aftermath of an IPO often sets the tone in the trading market for a considerable time. Whatever the motivation, underwriters will always seek to price the offering in such a way that it is effectively pre-sold by the time the underwriting agreement is signed, so that they are not at risk of holding an unsold block of shares.

The underwriters in an IPO are compensated by taking

a negotiated spread between the public offering price at which they sell the shares to investors and the price at which they buy the shares from the issuer. IPOs of equity securities of reputable issuers by reputable underwriters almost invariably are priced to yield a 7 percent spread to the underwriters. By contrast, debt offerings are typically priced to yield a 3 percent spread to the underwriters. Marginal IPO candidates brought public by less well-known underwriters have been known to pay a spread up to 15 percent, depending on the size of the offering, the marketability of the shares and other factors.

The Financial Industry Regulatory Authority (FINRA) regulates the compensation that underwriters may charge to issuers. Their analysis of underwriter compensation includes a wide range of items, including any warrants or other benefits given to the underwriter within a defined period of time. If the compensation is found by FINRA to be excessive, they can effectively cripple an IPO by that underwriter. Issuers who enter into arrangements with underwriters to conduct a private offering in advance of an IPO should be careful not to grant them compensation for the private offering which will later cause problems in the IPO. Counsel can assist by reviewing the proposed compensation in advance under published FINRA guidelines.

Listing and Trading

An integral part of the decision to go public is where to list the issuer's shares after the IPO. A listing on the New York Stock Exchange (NYSE) is usually considered preferable for the prestige and market efficiency that it brings. This is important for the issuer because it ensures that sellers of the stock will receive the highest price for their holdings. Trading on the NYSE still takes the form of exchanging bid prices and ask prices through a single physical location on the floor of the exchange. However, many IPO issuers do not meet the high standards for NYSE listing and instead list their shares on the NASDAQ Stock Market. NASDAQ operates through a computerized system linking thousands of terminals around the country, and orders are matched and executed through an automatic clearance system. In fact, some

IPO Pricing Reform

The process of pricing an IPO has lately come under reconsideration by various market participants, in light of the problems with IPOs encountered during the 1990s. Some advocates of reform have promoted the idea that IPOs should be priced based on bidding procedures, rather than through subjective judgments by lead underwriters, who have inherent conflicts of interest. The IPO by Google and a limited number of other IPOs in recent years were conducted by bidding procedures, in a break with traditional underwriting practices. Whatever the merits of bidding procedures, it is unlikely that most IPO candidates will have the clout to influence underwriters to set up a bidding process the way that Google was able to do. Any pricing reform will need broad support from institutional investors and the SEC, since brokerage houses in general oppose this type of reform.

issuers (the most famous of which is Microsoft) began their publicly traded existence on NASDAQ and have remained there long after it was clear that they could meet the listing requirements of any exchange.

A recent trend in the listing of IPO companies has been to eschew listing in the U.S. altogether and list on the AIM market on the London Stock Exchange. AIM is specifically focused on smaller, growing companies. In recent years, NASDAQ listing standards and substantive regulation have increased very significantly, leaving many smaller issuers scrambling for a listing. Many of these small issuers have found a warm reception on the AIM market, which was established on the principle of looser listing standards. Also, significant volume on the equity markets generally has shifted to the London Stock Exchange in recent years, as Sarbanes-Oxley and U.S. financial regulation in general have increased. It is unclear whether an AIM listing will prove to be a long-term benefit to a strong IPO candidate which is centered in the U.S.

A Brief Summary of Public Company Obligations

An essential part of the decision to go public is a consideration of the substantive rules and reporting obligations that apply to companies registered under the Exchange Act. Since the passage of the Exchange Act in 1934, public companies have been required to file with the SEC annual and quarterly reports on Forms 10-K and 10-Q containing financial statements that meet the requirements of SEC Regulation S-X. Regulation S-X prescribes standards that auditors must comply with and requires public companies to conduct annual audits and comply with various additional substantive requirements that are expensive and tend to restrict the public company's flexibility to do certain transactions at certain times. In addition, a wide range of material developments like contracts, changes in officers and directors, and acquisitions and divestitures must be promptly reported on Form 8-K.²⁰ The goal of these disclosure requirements is to require the issuer to disclose all material developments on a current basis, except for certain very limited circumstances and for a very brief period of time.

Following the revelation of various management and accounting abuses in the late 1990s and early 2000s, Congress hurriedly passed the Sarbanes-Oxley Act (Sarbanes-Oxley) in 2002. Sarbanes-Oxley imposed several new, and quite onerous, requirements and restrictions on public companies. In a departure from the underlying philosophy of the Securities Act and the Exchange Act to only require disclosure and leave corporate conduct largely to the discipline of the marketplace, Sarbanes-Oxley imposed a large number of normative rules on public companies. Among other things, Sarbanes-Oxley requires public company executives to certify to the financial statements and other disclosures in SEC-filed reports; requires publicly-traded companies to institute tight internal financial controls that the auditors must publicly evaluate; establishes conflict of interest rules for auditors who render non-audit services to the issuer;

prohibits loans to executives; imposes independence and financial literacy requirements on boards of directors; and mandates whistle-blower protections. The same regulatory climate that gave rise to Sarbanes-Oxley also encouraged the stock exchanges to impose a substantial number of corporate governance requirements on the companies listed on their facilities. The result was to greatly multiply the burden and expense of compliance for public companies.

One provision enacted with Sarbanes-Oxley which has far-reaching consequences, led the SEC to adopt "up-the-ladder" reporting rules for lawyers involved with public companies. Under these rules, an attorney who becomes aware of "credible evidence" of a material violation of federal or state securities laws, fiduciary duties "or similar violation," must report the violation to the company's chief legal officer or chief executive officer. If the reporting attorney does not receive an appropriate response to the issue from those officers, then he or she must report the matter to independent members of the board of directors.

At first glance, the up-the-ladder reporting scheme appears to follow logically from the uncontroversial idea that the attorney's client is really the corporate entity rather than the managers. In practice, these rules have created a number of dilemmas. Legal practitioners have argued that these rules will discourage managers from consulting with counsel about sensitive issues if they believe the attorney may second-guess their judgment and go over their head on the issue. The rules also have the potential to create very difficult situations for counsel, who face firing or the prospect of very awkward relations with their day-to-day contacts if they report matters over which they have misgivings, but who face SEC sanctions if they do not report matters which later turn out to be serious. Perhaps the best practical advice to managers of a public company in relation to these rules is that they should certainly be encouraged to consult with counsel on difficult issues on which they have a good faith

²⁰ The Form 8-K rules were substantially revised in August 2004 to add a large number of new items to the list of triggering events, and to tighten various perceived problems with 8-K reporting. As a result of these Form 8-K changes, public companies are currently in something like a continuous disclosure process.

belief about the legality. At the same time, they should be aware that the lawyer might have a duty to report a matter of dubious legality to a higher authority. As the rules make clear, the attorney-client privilege that protects communications between a manager and a lawyer belongs to the company rather than the individual manager. As a result, a company attorney may be compelled to disclose to other responsible company officials questionable conduct by a company officer or employee, even if it is relayed to the attorney with the expectation that it will remain confidential.

Many participants in the public markets have expressed dismay at the weight of the burden and the inefficiency imposed by Sarbanes-Oxley. Over the last several years, the U.S. equity markets have lost significant trading volume and listings to various foreign markets, chief among those the London Stock Exchange, where the regulatory burden on listed companies is substantially lighter. In the current political climate, it is unlikely that Congress and the SEC will cut back on the provisions of Sarbanes-Oxley. Quite the contrary: the SEC recently promulgated additional and very detailed rules dealing with director independence and disclosure of executive compensation. In the wake of the 2008 financial crisis and election of President Obama, the mood in Congress suggests that the federal securities laws are to be subject of a major overhaul. While many of the proposed changes mentioned so far will not directly affect the public offering process for corporate issuers, other changes, like restrictions on executive compensation, are likely to pass in some form. The spirit of improving markets through additional regulation is very much alive as of the publication of this book.

One consequence of going public, which is frequently overlooked by managers of an emerging business, is the imposition of various SEC rules which apply to the purchase and sale of company stock by “insiders.” The most significant of these rules are those adopted under Section 16 of the Exchange Act and SEC Rule 10b-5. These provisions are complex, but their effect is to severely limit the opportunities for management and other insiders with special access to company information to buy and sell its stock.

Alternative Routes

The managers of an emerging business are often led to believe that it is cheaper, and therefore preferable, to go public by merging with the publicly traded shell of another (invariably unsuccessful) company. The principals of the unsuccessful company, who are trying to wring some last bit of value out of their failed venture, often initiate these suggestions. It is almost always a mistake to go public by this route, for several reasons. Because the transaction is in form a merger, it exposes the emerging business to the unresolved past liabilities of the public shell. Even if these liabilities can be resolved or mitigated, federal and state regulators look askance at this route to going public. An emerging business that is strong enough to launch a successful IPO should do so without resorting to this technique. Even if the emerging business wishes to become a publicly registered company without engaging in a public offering, SEC rules allow companies to do so voluntarily without any need for an already-existing shell.

Public companies also have the obligation to solicit proxies according to SEC disclosure rules in advance of annual and special shareholder meetings. These disclosure rules subject the company’s executive compensation practices and decisions to public scrutiny (and often misinterpretation). The SEC recently revamped the proxy disclosure rules to require the issuer to quantify and list the aggregate of all compensation paid to key executives, resulting in some very large (and largely notional) sums. The issuer is also required to discuss all of the significant assumptions and factors which were reviewed as a part of determining compensation for the key executives. When the proxy is solicited as part of approving a major transaction or other matter requiring shareholder approval, a preliminary version of the proxy statement must be filed in advance for review with the SEC, whose staff may insist on additional disclosures. Even when only relatively mundane matters are subject to a shareholder vote, the proxy statement disclosure requirements are very extensive.

Public company status also subjects management to the possibility of a public takeover through either a merger proposal, a tender offer or a proxy contest. If a public company's stock price remains low for a period of time, or if its managers are perceived to be under-performing, then other companies in the same or a similar industry may make a merger proposal or launch a tender offer to take over the company while the market price is attractive. Depending on the state of the markets, financial buyers may also perceive an opportunity in a takeover of the public company. In these times, the stock markets are well-populated with participants who can identify a good takeover candidate and have various ways of facilitating the efforts by strategic or financial buyers to take over a company.

Conclusion

The decision to take a closely held company public presents a very complex proposition for the management of an emerging business. The emerging business must decide whether conditions in its business and in the stock markets are advantageous for the IPO. The business must also weigh the benefits and burdens of public company status well in advance of any decision to do so. On the one hand, access to capital and a readily marketable currency with which to make acquisitions are very powerful tools for a growing company. However, for a company without huge growth prospects, the costs and restrictions of publicly traded status can stifle the company's management and expose them to sudden changes and even a loss of control of the company. A failed public company creates several layers of profound trouble for its managers, who may spend years attempting to put their careers back on track. An emerging business should consult with experienced counsel and have extensive discussions with prospective underwriters before making the decision to go public.

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Employee Equity Incentive Plans

by Michael J. Drooff, Esq. and Peter T. Beach, Esq.

Many emerging businesses compensate their managers and employees in part based on the value of the company's stock. Equity-based plans often provide needed incentives for managers to improve performance, while conserving cash that is needed for working capital or other purposes besides compensation. Although various legal provisions prevent equity incentive plans from being used as capital-raising devices, they can, in fact, be attractive compensatory devices for emerging businesses. As in other areas that touch on an emerging business' stock, properly planned equity incentive plans can make the difference between achieving and thwarting the emerging business' strategic objectives.

The first planning issue that must be addressed in establishing an equity incentive plan is how the plan should be designed to serve the corporate goals of a particular emerging business. For example, giving large incentive packages to the CEO or a small group of officers, who may have a direct and disproportionate role in promoting the company's stock value, may tend to alienate other officers and employees whose contribution to stock value is considered important but perhaps more indirect. On the other hand, giving stock-based compensation to line employees who may have little control over the business' stock value, may not serve any useful corporate purpose other than conserving cash. Such employees may feel short-changed if the equity component of their compensation does not perform as expected. Of course, for small businesses with little or no uncommitted cash, where every employee is a key employee, equity incentive plans can potentially give participants extra compensation where none is otherwise available. Just as the goals and resources differ among emerging businesses, so will the decisions around designing an appropriate equity incentive plan.

There are many complex consequences of setting up an equity incentive plan. Perhaps the most obvious issue (for certain types of plans) is whether management is comfortable having employees as co-owners of the business. Under various states' corporate laws, including

Tax and Accounting Consequences

The ramifications of setting up an equity incentive plan must be carefully planned from both tax and accounting perspectives. Different types of plans work best with different constituencies and in different situations. For example, for a phantom stock plan, which relies on cash being distributed to participants periodically in a way that captures the increase in the value of the emerging business' stock, each distribution date on which the plan interests are in-the-money results to the company in:

- A distribution of cash;
- A related tax withholding obligation;
- A charge to earnings; and
- A deduction for income tax purposes.

At the same time, each employee receives cash but incurs an income tax liability. In a rough sense, the tax and accounting benefits and burdens that accrue to the company and participants are inversely related.

New Hampshire and Massachusetts, shareholders have a broad right to seek and receive information about the company, such as financial statements, which a manager might otherwise choose to keep confidential. If control of the business is contested, employees may refuse to side with management, either out of calculating self-interest or a petty grudge of the sort that arises with unfortunate regularity in the employment relationship. A large group of employee-shareholders can also make the process of selling a small business more complicated because they have an expectancy in the company's stock which often needs to be satisfied by the acquirer.

Accounting Issues

The key accounting issues that must be addressed for equity-based compensation arrangements are:

- Whether the plan gives rise to compensation that

New Rules About Nonqualified Deferred Compensation

In late 2004, Congress enacted tax rules under Section 409A of the Code that govern nonqualified deferred compensation paid by both public and private companies. These rules significantly changed the landscape regarding taxation of nonqualified deferred compensation plans. The new rules generally accelerate the taxation of deferred compensation where the employee is considered to have an unacceptable level of control over receipt of the deferred amounts. One of the most surprising features of the new rules is the extent to which they affect equity-based compensation plans.

While statutory stock options, typical restricted stock units and “plain vanilla” non-statutory stock options, are not affected by the new rules, other equity-based compensation plans are. Discounted non-statutory stock options, stock appreciation rights, and any other forms of equity-based compensation not specifically exempted from Section 409A must satisfy the nonqualified deferred compensation plan rules, which:

- Require advance elections to defer or re-defer compensation;
- Limit distributions to pre-specified dates or permitted events;
- Bar accelerations;
- Delay separation-from-service distributions to key employees of market-traded companies for six months;
- Mandate reflecting these rules in the governing plan document; and
- Restrict offshore funding and funding that is tied to changes in the plan sponsor’s financial health.

The new rules apply to employer-employee arrangements, arrangements between partners and partnerships and between independent contractors and the recipients of their services. Failure to comply with the rules results in taxation of the deferrals under the plan, a 20 percent additional tax and cumulative interest on the underpayments resulting from taxing each deferral from its deferral date. These new nonqualified deferred compensation rules are currently explained in final Treasury Regulations issued under Section 409A.

must be given accounting recognition;

- When and how compensation cost should be measured;
- The accounting period in which compensation cost should be recognized as an expense;
- How the related tax effects should be treated;
- How the balance sheet accounts should be classified; and
- How the earnings-per-share calculation is affected.

As of the end of the first quarter of 2006, all public and private companies were required to account for stock options under FASB Statement 123 (as revised, 2004) (123R) using the “fair value” method. The “fair value” method seeks to value an option as of the time of grant, using one of several accepted mathematical formulas, such as the Black-Scholes option-pricing model.²¹ The grant date is the date on which the employer and employee agree to the terms of the transaction. While the compensation cost is fixed at the date of grant, such cost will be recognized as an expense over the vesting period. The tax treatment of equity-based compensation arrangements gives rise to tax deductions, which often arise in different amounts and/or different periods from compensation expense recognized for financial reporting purposes.

Tax Issues, Including the Nonqualified Deferred Compensation Rules under Section 409A

The tax issues that arise for equity-based compensation plans generally involve the issue of when the employee (or other recipient) is considered to have income and the employer is entitled to a corresponding compensation deduction. Equity-based compensation plans may result in tax consequences on three different dates: the grant date, the exercise date and the disposition date. There are no tax consequences to either the employee or the employer on the date of grant where an equity interest granted has no readily ascertainable fair market value on the date of grant. This will always be the case with options that are not publicly traded, but the fact that shares of a start-up company may be difficult to value on the date of grant does not

²¹The Black-Scholes model represents an equation developed by two University of Chicago economics professors that holds that the value of an option depends on several variables, including the exercise price of the option, the statistically-derived volatility (i.e. beta) of the underlying stock, the length of the option period and the risk-free interest rate. Because the statistical volatility of a private company cannot be ascertained, Black-Scholes is not generally used to value private company options.

mean that the shares will not be subject to tax upon grant. Rather, to avoid such treatment such shares must be non-transferable and subject to a substantial risk of forfeiture.

With respect to equity-based compensation, the exercise date is generally a taxable event for both the employee and employer, except where the Internal Revenue Code (Code) expressly provides for an exemption from tax on exercise, as it does for statutory stock options and employee stock purchase plans. When an employee disposes of stock acquired in an equity-based compensatory transaction, the disposition is generally treated as a capital transaction, subject to the long- and short-term requirements of the Code. Statutory stock options, however, are subject to certain holding-period requirements that can cause an employee's disposition of stock received under exercise of such an option to be taxed as compensation at the time of disposition.

Without attempting to describe all the many variations and combinations of equity incentive plans, they fall into three rough groups for discussion purposes: (i) plans that pay participants cash based on some real or imputed increase in the value of stock, (ii) plans that grant participants actual stock or the right to purchase stock at a discounted price, and (iii) plans that buy and hold stock for participants in complex tax- and ERISA-qualified trusts.

Cash-Based Plans

Cash-based plans consist mainly of phantom stock and stock appreciation rights (SAR) plans. These plans have the virtue of not actually conferring stock ownership, and the statutory rights associated with such ownership, on a group of employees. Instead, they require the payment of cash by the company to the participants. In a phantom stock plan, the participant may be entitled to receive a cash payment from the company equal to the value of a specified number of shares of the company at a certain date or dates or upon request of the participant. Under an SAR plan, the company grants a participant the opportunity, within specified time limits, to exercise the SAR and receive an amount of cash equal to the difference between a pre-determined base value for a

specified number of shares established as of the grant date (the base value) and the value of those shares on the exercise date.

The tax consequences of both types of plans are to treat them as a cash bonus, i.e., the company and the employee simultaneously take a deduction and realize ordinary income, respectively, in the amount of the distribution at the time it is paid. These types of plans are generally subject to Section 409A (with certain exceptions for grandfathered plans and public company plans). In both cases, plans will not have to comply with Section 409A if there is no existing value built into the right as of the date of grant. The proposed IRS regulations accomplish this result by excluding from Section 409A any SAR for which the base value is equal to or greater than the fair market value of the underlying stock on the date of the grant. It is more difficult for a phantom stock plan to satisfy this requirement because such plans frequently provide for a payment equal to the full value of the stock on the date of exercise. Unless the phantom stock was issued when the stock had no value, the plan would be subject to Section 409A.

Restricted Stock, Stock Purchase and Stock Option Plans

The second group of equity incentive plans includes restricted stock, stock purchase and stock option plans. Under a restricted stock plan, the company grants a plan participant a number of shares of company stock subject to certain restrictions, including forfeiture provisions if, for example, the participant leaves the company before the passage of a specified period of time. Until the forfeiture provisions lapse, the company holds the shares, although the participant may have the right to vote and receive dividends on the shares. The tax consequences of a restricted stock plan (absent an election under Section 83(b) of the Code to recognize income immediately) are that the participant does not realize income, and the company is not entitled to a deduction, until the date on which the forfeiture provision lapses. Restricted stock plans are generally not subject to Section 409A.

A stock purchase plan, by contrast, allows participants

the opportunity to buy shares outright on a regular or periodic basis, typically through regular payroll deductions. If the stock purchase plan meets certain strict requirements, including a holding-period requirement, the stock acquired by participants qualifies for favorable capital gains treatment upon later resale. Stock purchase plans, such as described here, are generally not subject to Section 409A because they either lack any deferral element or they qualify as an employee stock purchase plan under Section 423 of the Code.

Under a stock option plan, a participant is granted the right to purchase a specified number of shares of stock from the company at a specified price, usually the fair market value on the date of grant. Such an option is typically exercisable only after the passage of a period of time during which the participant remains with the company. A stock option plan can be designed to give participants tax-qualified “statutory stock options” which, if certain restrictions are observed, are not taxed until the stock is resold after exercise, and then only at the capital gain rate. Under such circumstances, however, the company is not entitled to an expense deduction relating to the options or the shares into which they are converted. If the options do not qualify as “statutory stock options,” then they are considered “nonqualified stock options.” Under a nonqualified stock option, the participant is taxed at the time of the exercise of the option in the amount of the spread between the exercise price and the shares’ fair market value, and the company is entitled to take a corresponding deduction at the same time. Incentive stock options are not subject to Section 409A, nor are nonqualified stock options that are issued with an exercise price greater than or equal to the fair market value of the underlying stock on the date of the grant. Nonqualified stock options that are issued at a discount (i.e. where the exercise price is less than the fair market value of the underlying stock on the date of grant) are generally subject to Section 409A.

ESOPs

The third group of equity incentive plans consists of employee stock ownership plans (ESOP), in the narrow sense of that term. These plans involve a much greater

degree of complexity and expense than the other types of plans described above, since they must comply with various tax and ERISA requirements on a continuous basis. In an ESOP, the company makes specified periodic contributions for the benefit of plan participants to a separate trust set up to purchase or receive grants of company stock. Often the trust will take out a bank loan to buy a large block of company shares upon the plan’s establishment or to later buy additional company shares, in which case the plan is referred to as a “leveraged ESOP.” A participant is entitled upon termination or retirement to receive a distribution of either the company stock assigned to his or her account, or the cash corresponding to that stock if the trust agreement requires the company to repurchase the stock upon such an event. From a tax perspective, the company is entitled to a deduction when each contribution is made to the trust, although the participant is not taxed until his or her interest is distributed, perhaps years later. Banks lending to ESOPs also enjoy certain tax benefits, making such loans attractive to bankers who understand them. ESOPs are not subject to Section 409A.

In addition to providing tax benefits to the company and participants, an ESOP can be used as a vehicle for financing the company. The ESOP can take out a loan, the proceeds of which can be used to purchase stock directly from the company if it needs capital. Alternatively, if the company is interested in establishing a limited secondary market in its shares, the proceeds of the bank’s loan to the ESOP can be used to purchase company shares held outside of the trust without depleting company funds.

Valuation

An important issue in many types of equity incentive plans is how to value the company’s stock for purposes of determining the compensation to participants. If an emerging business is not publicly traded, there is no actual market to provide an answer to this question. The process of arriving at some value which can be called fair market value, is necessarily a complex one which will depend on all of the circumstances. After carefully considering the emerging business’ industry segment and

operating characteristics, it is usually possible to devise a formula that the company and plan participants can agree-to as roughly fair and which will survive court challenge to the extent it approximates the fair market values determined by taxpayer and government experts at the time of trial. The alternative of engaging a valuation expert each time a round of grants is made is generally considered too expensive for emerging businesses to resort-to on a regular basis. The final regulations under Section 409A take some pressure off this issue by providing a more relaxed set of standards for companies that have been in business for less than 10 years.

Fiduciary Considerations

Until the wave of corporate and accounting scandals broke in 2000, the adoption of equity incentive plans and awards under those plans was examined by the courts, if at all, under a common law doctrine known as the Business Judgment Rule. Under the traditional interpretation of the Business Judgment Rule, board action would be immune from judicial second-guessing as long as the action served a rational business purpose. Even very large option grants to executives went largely unchallenged, as they arguably created incentives for executives to enhance shareholder value. In the wake of recent case law in Delaware and elsewhere, however, it is clear that the standard under which equity incentive plans will be examined has been raised substantially. Although the courts purport to continue to apply the Business Judgment Rule to board decisions in this area, in practice they have become much more skeptical of board decisions. Fortunately, this judicial skepticism has been applied to public companies more than private companies. Also, private company investors have tended to understand the need for appropriate incentives for officers, directors and key employees—and have been in a position to block awards that they deem excessive. Nevertheless, it is wise for an emerging business to consult with counsel prior to making large awards under an equity incentive plan. Counsel can help review the circumstances and the board's rationale to determine whether the awards present a potential risk. Counsel can also determine whether the awards exceed the volume

limitations under relevant securities laws.

Many companies have also recently found themselves embroiled in a scandal regarding various practices relating to the pricing of stock options. Almost all companies aim to issue stock options with an exercise price that reflects the fair market value of the stock as of the time of grant. Historically, companies adopted various methods of pricing their options that sometimes only loosely approximated fair market value. The motivations behind these practices were many and varied. Sometimes companies genuinely attempted to smooth out short-term fluctuations in market prices by adopting various averaging strategies that relied on market prices over the recent past. Sometimes companies were tardy in issuing option paperwork and saw no problem in pricing the options at a price that prevailed in the market at the time when the recipient and the company discussed the option grant. And some companies apparently sought to give executives options that were already in-the-money and clearly had substantial value.

The SEC has recently focused on these types of practices at public companies and has taken the position in a number of cases that the value given to optionees represented undisclosed compensation of a material nature. Because the compensation that was inherent in the option grant was not taken as a compensation expense for financial reporting purposes, the public company's financial statements might have been materially misleading to investors. Private companies, of course, are not subject to SEC line-item disclosure rules and are generally not the target of SEC enforcement proceedings, but emerging companies should focus on the tax consequences of this emphasis on fair market value pricing. Emerging companies should not, for example, delay the preparation of grant documents after option terms have been agreed upon with executives. They should also take valuation issues seriously and consider their recent history of stock issuances in setting option prices.

Compliance and Disclosure Issues

Federal and state securities laws have evolved over the years to accommodate most of these types of plans,

provided they contain certain limitations and safeguards against their misuse as capital-raising devices. On the federal level, Rule 701 under the Securities Act provides non-public companies with a broad exemption from the federal registration requirements for equity-based incentive plans benefiting employees, provided that certain volume and other limitations are observed. In New Hampshire, RSA 421-B:17.I(h) provides an equally broad exemption from the state registration requirements for such plans. Most other states' blue-sky laws include analogous exemptions for equity plans. In Massachusetts an exemptive rule under MGL Ch. 410a, Sec.# 402(a)(13) broadly exempts securities issued under most types of employee benefits plans.

It should be noted, however, that these exemptions do not exempt plans from the anti-fraud provisions of federal and state securities laws. That is, the company that sponsors the plan must still provide meaningful disclosures about itself and its business and prospects to employees where they are required under the terms of the plan to put up out-of-pocket funds to acquire or exercise their rights to company stock. If the company's stock does not perform as expected for a participant and the company is responsible for a material disclosure deficiency, the participant is entitled to sue to rescind his or her payment to the company.

One troublesome securities law problem, which is inherent in certain types of plans, relates to continuing disclosure issues. For example, a plan that provides for a mandatory repurchase of a participant's shares upon termination of employment may put management in a difficult position when significant developments are pending. If management decides (perhaps justifiably) not to reveal the information and cashes the employee out at a price much lower than, for example, the merger price announced a short time later, the employee may bring a claim under the antifraud provisions of the securities laws alleging that he or she might have postponed termination if he or she had been apprised of the merger talks. Unfortunately, there is no easy course of action in such a situation if management is uncomfortable disclosing the pending developments.

Conclusion

Although employee equity incentive plans may not be used specifically for purposes of raising capital for the emerging business, if properly planned and executed they may nevertheless contribute substantially to the success of such a business. Experienced accountants and legal counsel should be involved in the design and implementation of these plans in order to avoid various pitfalls.

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About the Authors



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Michael J. Drooff is an experienced corporate lawyer specializing in securities matters and mergers & acquisitions. Michael represents small and medium-sized private companies in venture capital financings and syndicated private

placements. He also represents large public companies in public offerings and securities reporting and compliance work. In addition, Michael has an active mergers and acquisitions practice representing closely-held and public companies in asset purchases and sales, stock purchases and sales, cash and stock mergers and tender offers. He has played a significant role in numerous offerings of debt and equity securities by corporate issuers and offerings of debt securities by municipal issuers.

Corporate clients have included Fortune 500 companies, software companies, IT hardware manufacturers, major foreign private companies, insurance companies and industrial manufacturers. Prior to joining Sheehan Phinney Bass + Green in 1992, he practiced with a major New York City law firm.



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Alexander H. Pyle is a corporate lawyer with extensive experience representing established and emerging businesses in commercial and strategic transactions. His practice includes representation

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Peter T. Beach

Peter T. Beach has been engaged in providing tax advice exclusively since 1984. He began his career as a tax associate at Miller & Chevalier in Washington, DC and joined Sheehan Phinney in 1996.

In 2001, Peter moved to the West Coast as a partner in Ernst & Young's National Office West, specializing in the taxation of mergers and acquisitions. He returned to Sheehan Phinney in 2004.

Peter's practice covers a broad range of tax matters, including mergers and acquisitions, joint ventures, spin-offs, tax-free reorganizations, workouts, partnerships, S corporations, limited liability companies, international taxation, state and local taxation, and tax-exempt organizations. He has represented clients in many industries, including: software, telecommunications, healthcare, real estate, natural resources, private equity and venture capital, logistics and education. He has assisted both small private and large public companies in connection with tax planning and controversy matters throughout his career. Peter is also a frequent contributor to professional journals and presenter at tax seminars.

Sheehan Phinney is a full-service business law firm representing national and international clients with innovative approaches and practical solutions. A regional firm with four locations, the firm is known for professional excellence, practical counsel and commitment to both its clients and the communities it serves.



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