Chapter 15. Venture Capital Financing

By: Fred Tannenbaum*

I. Scope

15:1. In general

Venture capital is the lifeblood of emerging growth financing in the United States, if not the world. This chapter seeks to educate attorneys, entrepreneurs, founders, fund sponsors, investors, accountants, registered investment advisors and bankers working with small and middle-sized emerging businesses about the nature and nuances of this critical and often misunderstood type of financing.

This chapter provides an overview of the building blocks containing various components in any venture capital financing transaction: participants' respective concerns and expectations; an example of a business using venture capital financing to illustrate the various stages a business will pass through; the fundamental issues arising in a venture capital financing in detail, including the critical issue of how the business receiving the financing should be valued; how the respective parties might expect to share increases in value; a brief review of the required documentation in a venture capital transaction; the appropriate form of organization for a business that may be seeking venture capital financing; and finally a brief overview of equity based compensation arrangements and their tax aspects.

II. Venture Capital Financing: The Lifeblood of Growing Entrepreneurial Businesses

15:2. The role of venture capital in the U.S.

Venture capital fund investors ("VC" or "VCs") are professional investors who specialize in funding and building young, innovative technology driven enterprises. VCs are long-term investors who take a hands-on approach with all of their investments and actively work with entrepreneurial management teams to build great technology companies. VCs are not the only class of investors seeking outsized returns in innovative entrepreneurial led companies. Strategic investors, such as venture divisions of large companies, are also prominent, as are high net worth family offices, angel investor groups, hedge funds, sovereign wealth funds, and even an occasional private equity fund. While there are nuances in all of these subsets, we will paint them broadly and refer to them as VCs for this chapter.

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The venture financing climate has changed dramatically in this decade of the 2020's. Through 2021, the VC industry was booming with many records for the number of transactions, exits and dollars invested. Dramatic reversals in those key areas started in 2022 resulting from significant equity market contractions, meteoric interest rate increases, and collapses in some sector manias like cryptocurrency and NFTs. The residual repercussions included mass layoff in the tech industry including some bellwethers like Amazon, Salesforce and Alphabet, and significant declines in early stage company budgets, particularly in the sales and marketing function, in an attempt to position the companies for longer cycles before the next funding rounds to attempt to avoid running out of cash during a period of VC investment scrutiny and likely down rounds.

The trends continued through the fourth quarter of 2024, except the new proverbial "shiny object" is investment in artificial intelligence ("AI") companies. In fact, AI companies represented over 46% of the deal activity and close to 29% of the value of VC deals in 2024. The most precipitous decline in new investments in 2024 from the high water mark in 2021 was in climate tech investments.

While the fourth quarter of 2024 blossomed some fragrant green shoots, in reality early and late stage deal activity declined for three straight years, from 2022 through 2024. That being said, the dollar volume of transactions in the fourth quarter of 2024 eclipsed the fourth quart of 2023 by over 14%. However, the number of deals plummeted, actually dropping by a quarter in the same period. Much of the late 2024 venture funding may be attributable to larger deals, particularly in the AI space. To illustrate, out of 4000 deals closed in the fourth quarter of 2024, over 54% were made to just 15 companies which attests to the dramatic skewing. For venture growth deals in 2024, the average size deal was 7.7 times the median, the growth in late-stage VC deals far eclipsed the growth rate of seed and A round transactions. . Given the decline in valuations, and the dearth of exits due to the inaccessibility of the public markets coupled with higher interest rates and concomitant reduction in access to debt markets for merger and acquisition solutions, many venture backed companies have managed their cash resources must more zealously, abjuring the days of growth at any cost, and that cash conservation has elongated the length of time between rounds from 1.5 years on average to 2, which represents a 33% increase.

Valuation increases also skewed toward the larger deals. While valuations of D and higher rounds plummeted in 2023, they rebounded sharply in 2024, but did not reach the 2021 high water mark.

The number of "unicorns" (i.e., "startups" valued at $1 billion or more) declined to only 20 in 2024, the lowest level since 2020, when Covid first infected the world. The decline in IPO and merger-and-acquisition (M&A) activity as well as less than stellar up rounds contributed to a decline in more fund formation in 2024. Only $76.1 billion was raised across 508 VC funds. This represented a 6.5 percent decline from 2023 which, in turn, represented an over 30% decline from the high water mark of 2021-22. 2024 witnessed an uptick reaching $180 billion, although high profile and glamorous targets, like AI, were prime drivers.

Past downturns in venture capital financing have typically lasted about two years on average. For example, in the Dot Com crash from 2001 to 2003, venture capital funding fell from $200 billion prior to that period to $15 billion (measured in 2024 dollar terms). From the Great Recession of 2007 to 2009, funding plunged from $50 billion to around $15 billion.

In terms of new funds, the trend is toward existing funds from established funds with proven track records and management teams. 2024 represented the first time in over a decade that the number of newly closed funds was less than those of established funds. Only ten funds accounted for over 56% of investors' commitments. Given valuation compression and the difficult minefield involved in finding and nurturing an early stage company, the preference for being tried and true and not wanting to take any more risk in an already risky investment category is understandable.

The investment cycle, in turn, has grown longer which shows up in statistics on "dry powder", i.e. uncalled capital in committed funds. Existing funds in 2024 vintage amassed a total of $308 billion in uncalled capital. Given the structure of these funds, they have limited investment periods, typically five years, to deploy the capital or forego the opportunity to call it. The interesting conflict then arises -- does a general partner do what is best for investors and, if the right opportunities at the right valuations do not present themselves, simply not invest and therefore ultimately lose the opportunity to call the capital? Or does the manager call the capital, and hope for the best, and therefore continue to earn a management fee on the increased called capital. We all hope for and expect the former. This suggests that investors were more inclined to invest with fund sponsors who had significant track records and therefore theoretically less risky.

Many VC funds have also slightly modified their investing approach as well as relations with their limited partners. Many VC funds are simply taking longer to invest, hoping to catch the proverbial knife at the bottom of the valuation butter dish. This delayed approach delays the need to raise money for a subsequent fund (or perhaps makes a virtue out of necessity as the limited partner investors' appetite for new funds is likely chastened by the carnage in the marketplace). Some firms in fact are actually reducing their management fees, at least temporarily, or basing the fees on a percentage of capital actually called and investment instead of the typical fee based on commitments.

Other trends emerging from the decline in funding are actually reminiscent of past down cycles. These include a barbell-- either highly glamorous technologies like artificial intelligence to more mundane and less risk non-technical This schism has become controversial. At least one prominent tech co-founder and CEO, Alex Karp of the unicorn Palantir, even wrote a best-selling book chastising (if not excoriating) many VC investors for playing it safe and boring instead of trying to make vast technological breakthroughs which would dramatically advance society. Some large funds have also started trying to mitigate their risk by diversifying along the life-cycle spectrum to later stage buyouts, minority investments or growth equity.

Tighter investment dollars have not only changed the behavior of many VC funds but also altered the focus and strategy of many VC backed companies. Several companies have attempted to lower their burn rates, recognizing that funding cash shortfalls will be delayed and possibly at a significant markdown in valuation. Many investors have attempted to exit their investments, given the absence of traditional means such as sales and IPOs, to a rapidly developing secondary market, enabling earlier investors some liquidity and the secondary buyers perhaps attractive discounts in what they perceive to be solid companies.

The relative decline in the number of new funds (and I just mean relative because on an absolute basis, the fund and dollar volume is huge) is partly attributable to human nature, where when times are good, investors have a fear of missing out on great opportunities when, history teaches us, that the best time to invest is often when conditions and the future look the bleakest. The decline is also attributable to a multiple of objective factors. These include the decline in the public equity markets means that family offices, universities, and endowments are therefore under allocated to public equities and over allocated to VC and other private investments and therefore need to reallocate their portfolio to keep within their target allocations. While investing by strategic investors is often overlooked, down markets is the time that savvy and opportunistic strategic investors participant with more fervor. For example, in early 2023, Microsoft invested over $10 billion in OpenAI which created ChatGPT and is an underpinning of Microsoft's AI strategy. Microsoft had earlier invested $1 billion in the company. Corporate venture capital declined slightly in 2024 from the prior year, yet still remains at 23% of completed deals and 56% of deal value.

Venture capital funding in women-founded companies displayed mixed progress in 2024. On the one hand, the amount of capital invested in female-founded companies increased in deal value but decreased in number of companies, again suggesting that deals are skewing larger. Similarly, the number of funding transactions involving women-founded companies declined in 2024 from 2023 but still represented the second highest level ever. 6.4% of all VC transactions in 2023 and 5.8% in 2024involved Targets with founders who are all women, and 23% were in companies where there was at least one female founder. All this being said, 2022 witnessed a decline in the percentage of VC funding allocated to all female-founded firms to only 1.8% in 2024 from 1.9% in 2023.

While we have been focusing on the equity side of the capital structure, venture debt had a very strong growth and presence in 2024. While the number of transactions declined from 2,307 in 2021 to 1,341 in 2024, the lowest point since 2014, the deal value was a record, exceeding $53 billion. Most venture debt loans were made at the growth stage, which is understandable given the absence of more conventional lenders at that end of the market. The average size loan increased from $16 million to $18.2 million whereas the median was $2.6 million, again demonstrating that much of the venture capital in 2024, whether in debt or equity, was skewed toward larger deals. Loans to AI and healthcare companies were particularly strong in 2024.

Any savvy investor will tell you that one of the first questions they ask when they first analyze a Target is--how and when do I exit? Axiomatically, a Target can perform miraculously well but if it does not pay dividends, as most venture backed companies do not, and does not go public or sell, the only gain the investor may have rests on a piece of paper, often which is not bankable. 2024 marked a continuation of the low level dramatic turndown in VC-backed company exits. While 2024 witnessed a huge raw number of exits on an absolute basis, $149 billion worth, on a relative basis to 2021, this figure represented an almost 100. The continued elevated interest rate climate and concomitant cost of capital contributed to the precipitous decline. Initial public offering ("IPO") activity continued at a low number and value level. A majority of the exits still occur before the Series C stage level.

Given the rapid improvements in and declining costs of technology (storage, cloud based and infrastructure software for financial and other back office requirements, and processing power) as well as marketing (CRM and other sale and distribution tools), the investment required to launch emerging growth companies has been reduced by, what some estimate as, a factor of 15 over the past 15 years. This dramatic reduction allows the same investment dollars to be spent more productively and focused on the core business instead of the infrastructure.

VCs invest mostly in young, private, technology-driven companies that have great potential for innovation and growth. They have been instrumental in developing the following sectors: software, e-commerce, life sciences such as biomedical and biotechnology, many things as a service (such as software as a service, mobile as a service and platform as a service), internet, computer hardware and software, financial technology and the communications industries. In the last five years, the VC industry has also committed itself to investing in the AI and machine learning, autonomous unmanned vehicles, clean technology sectors, which include renewable energy, healthcare particularly the revolution in biology, environmental and sustainability technologies and power management. However, VCs also invest in innovative companies within more traditional industries such as consumer products, particularly new food and agricultural tech, manufacturing, financial services, healthcare services, and business products and services.

Most VC firms raise their funds from institutional investors; pension funds, insurance companies, endowments, foundations, family offices, and high net worth individuals. The VCs managing the funds should normally have a fiduciary responsibility to their fund investors. That being said, fund documents typically disclaim fiduciary duties to the extent permitted under law, which will be discussed infra.

The term VC and "angel" investor will be used interchangeably throughout this Chapter. The main difference is that angel investors typically invest at an earlier stage than VCs and often are not as institutional and professional as VCs. Every rule has exceptions and many professional and institutional angel funds proliferate.

15:3. Distinguishing characteristics of a venture capital investor

VCs are typically long-term investors who usually take a very active role in their portfolio companies or are aligned with a lead investor who is actively engaged. When a VC makes an investment in a portfolio company, the fund does not expect a return, on average, on that investment for five to 10 years. The initial investment is just the beginning of a long relationship between the VC and entrepreneur. VCs promise to provide great value by providing capital and management expertise, as well as introductions to others who might be helpful to the growth of the company (such as a talent network, suppliers and customers). VCs often are invaluable in building strong management teams, managing rapid growth, and facilitating strategic partnerships. Of course, if portfolio companies grow and need additional cash, VCs cannot always be expected or willing to continue to infuse new capital, either because of diversification principles or appetite for the risk. This sometimes leads to tension and conflict between the founders and VC as the relationship evolves.

The main distinguishing characteristics of a VC fund investment from a private equity fund are that the VC fund typically obtains a minority interest in the company in which an investment is being made (the "Target"). Any control it may have is negative control by virtue of protective provisions in governing documents as well as seats on the board. A VC-backed company will not be "bankable" or have any bank debt, at least until later in its evolution when it has proven its concept and starts generating recurring revenues. At that point, venture debt or some other form of senior secured debt financing may be more obtainable.

15:4. How do venture capitalists analyze a possible investment?

The VC will analyze a possible transaction by using two methodologies, an "objective" economic valuation approach and a more subjective business analysis. The more subjective business analysis evaluates five basic components of the Target:

- *Size of a Total Addressable Market*. Obviously, the cure for cancer has a much greater prospective interest than a slightly improved widget. Is the approach truly revolutionary or just evolutionary? The greater the prospective size of the total addressable market and the less of a niche market, the greater the interest as the market share required for success need not be as high. Great care must be exhibited in determining the size of the "addressable" market. If you are developing a new gluten free ice cream bar out of soy, it would not be fair to say the total market is all food products, but rather all ice cream or all desserts and certainly not all food. This concept is easier said than done and as much art as science as many assumptions are built in, including pricing, substitution of other products, willingness to substitute, time lag in adapting, inertia or contentment, and geographic and regulatory obstacles.
- *Management Team.* How talented and experienced is the Target's management team? How mature? How businesslike? Have they done this before or are they like Andy Hardy and just wanting to put on a play? What ethical and moral virtues and values do they have? How receptive are they to professional VC involvement? What is their character and ethical background? Their drive and intensity? Their ability to work together as a team? Their realistic expectations about the time, place and manner of the progress of the company.
- *Business Model.* How realistic is the Target's business model? How scalable (i.e., able to grow and repeat) is it? How novel is it? Is it truly revolutionary and likely to displace existing market participants? Is it just evolutionary, a better, newer and improved version of the same function? When does it start to break, even from a cash standpoint, or will it keep using cash as it grows (like most businesses)? Are revenues non-recurring, meaning they are not certain and just on a purchase-by-purchase basis? Or are they recurring, tied to one or multi-year guaranteed contracts. The latter form of revenues is certainly more valuable since you have more visibility about the repeatable nature and certainty of the revenue stream and command a higher valuation.
- *Technology or Product.* How novel is the technology or product produced by the Target? How is it different than or competitive with the technology or products of others? How protectable is the technology or product? For example, is it susceptible to infringement or can it be designed around existing patents? As Warren Buffet would ask: how "wide a

moat" is there protecting the intellectual property?

- *Competition.* How much is there for the Target? How well capitalized? How focused on the threat from the Target? What are the chances of disintermediation of the whole approach from larger entrants (such as Amazon disrupting an e-commerce site selling books)?

III. Basic Stages and Structures of a Venture Capital Investment

15:5. Investment stages

A typical Target will evolve through various stages during its life cycle. Overlapping and contradictory terminology is often used to describe these various stages. Some call the "early stage" the "start-up" or "seed" stage, and others call it the "first stage." The terminology is not important; it is the concepts that are critical.

15:6. Investment stages-- Early or seed stage

The early stage is the initial formative stage of a Target. Early stage venture capital financing occurs typically after the "angel" round involving a rich patron and sometimes successful entrepreneur investors (as well as the entrepreneur's own cash, if any, as well as borrowings from friends, family, and credit card companies).

Despite the significant contractions in deal volume described above, the angel and seed stages remain relatively resilient. While the number of deals at this stage dropped over 26% in the fourth quarter of 2022 from its first quarter, the dollar value of deals for 2022 actually set a record and increased by 8.9% over 2021. This can be attributed to the strength of the pre-seed (i.e., angel and friend and family) stage and expansion of the seed stage activity. A new factor in 2022 was that founders delayed expenses or managed with less or made layoffs, and these savings built value, short term at least, and therefore positioned startups in a more mature light.

Median size of seed round deals in 2022 was $2.7 million, representing a 19.4% increase over the prior year. Despite the number of deals falling in the fourth quarter of 2022 as mentioned, the actual median deal size increased to $3.0 million, suggesting confidence in the future.[1]

The early stage is typically the most dilutive stage to the existing owners since the risk to the VC investors is highest, and the negotiating leverage of the entrepreneur who began the business or the existing management team (in this chapter, such persons are referred to generically as the "founder") is lowest since their product, service or model are not yet proven. Obviously, this is not always the case, since successful entrepreneurs or entrepreneurs who have a compelling product can typically find a way to pit VCs against one another and drive up value. A savvy founder, therefore, will balance trying to raise as much money as necessary with the desire to retain as much equity as possible so that less equity must be sacrificed in the subsequent stages. A wise founder will also attempt to obtain a VC who has great credibility and respect in

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the VC world. This sage VC will inoculate the Target with a patina of credibility and respect that may induce other investors to make commitments at the current or later stages of financing.

The early stage can be broken down into two phases; the seed money phase and the start-up phase.

The first of these phases, the seed money phase, is where an angel or sometimes a VC investor (although rarely will they write a check this small) infuses between $100,000 and $500,000 to cover the Target's formation and initial research and development costs and possibly even proof of concept costs. Dramatic advances in technology have dramatically reduced the costs necessary to start up a business. Cloud computing, software and platform as service models, memory and power of computers, and marketing and finance tools all serve to enable a Target to spend more of its cash on developing its product, not on the basic infrastructure and tools that any business needs. Little or no revenue has been generated at this point.

Biotechnology or software development firms typify investments in the seed money phase of the early stage. Lenders (except credit card lenders) are usually unwilling to loan to the Target or its founders at this stage since there is little or no tangible collateral or recurring revenue.

The second phase of the early stage is the start-up phase. At this phase, the Target has almost completed product development and begun initial testing or marketing of its product. The Target may have started to generate revenues, but losses or working capital demands far exceed these revenues. Lenders may be more willing to loan at this point, but their appetite for nonrecourse (unguaranteed) loans is doubtful. Additional equity investment, typically in the range of $500,000 to $10 million, can be expected at this stage. High technology companies beginning to ship or license their products and newly-formed fast-food restaurants and e-commerce businesses are illustrative of start-up phase investments.

15:7. Investment stages-- Growth stage

As the Target grows, it needs new capital either to fund working capital (customers do not always pay as fast as suppliers demand payment), fund operating deficits, purchase additional plant and equipment, enter new geographic markets, invest in more salespeople and marketing, invest in more product development (evolving to 2.0 from 1.0) or purchase new businesses or product lines. This capital usually is provided in new "rounds" of financing. A Target will frequently go through several additional rounds of financing prior to its ultimate initial public offering ("IPO") or liquidating event (such as a sale or merger).

The additional rounds of financing may be simply "add-on" or additional investments by the investors who made early stage investments, or new VCs may be brought in as well.

A VC fund will typically allocate a certain percentage of its fund, say 5-10% to any Target. Of that sum, the VC may invest 25-50% in the initial round and the balance (either all at once or in tranches) as the Target goes to the equity markets in the future. The VC will be paying more per share (in up rounds) as the business has grown but the tradeoff is there is hopefully less risk as the concepts have been proven and now the risks are more competitive and execution.

VC deals are structured with different letter denominations for rounds of financing. After the initial early stages, which tend to be for common stock, there would be a Seed stage. The seed stage may also have various different sub stages, called Seed-1, Seed-2, Seed-n. The same is true of the next stages, A, B, C etc. These later stage VC deals suffered a slight stabilization in 2024, predominantly in the latter half of the year. In the fourth quarter of 2024, the $15.5 billion of late-stage deals was the lowest quarterly volume since 2018. Values of late-stage deals also compressed at the end of 2042. In the last quarter of that year, there were only 58 US late-stage VC rounds valued over $50 million, a three-year low. The inaccessibility of the IPO market, timidity of investors no longer fearing missing out, and valuation metrics affected by higher interest rates, together with some level of doom and gloom or belief that values will go lower all contributed to these declines.

Classification is sometimes difficult because some will call Seed stage an A stage and vice versa, so the data on number and size of these deals is not really reliable.

Whether new VCs are initially brought in to invest at the growth stage or whether the existing VC makes add-on investments at a higher price per share, the Target might now be able to leverage itself with debt since it now has a successful track record and presumably is generating free cash flow from which to service debt or, at a minimum, meaningful and growing annual recurring revenues. Venture debt is not cheap. It is often ten or more points above the 10 year US Treasury plus warrant coverage and often contains financial and other covenants. [2]

Venture lenders are not immune from the impact of down rounds, decline in venture investing and overall increase in interest rates. In March 2023, Silicon Valley Bank, a pre-eminent publicly-traded venture lender with over $209 billion in assets, was shut down by the US Federal Deposit Insurance Company. This is, as of now, the second largest bank failure in US history. One of the bank's devastating decisions was investing a lot of its deposits in long term debt assets such a mortgage bonds. Those securities precipitously declined in value as interest rates rose and a significant asset markdown ensued.

15:8. Structure of investments

The structure of a VC investment will inherently be a function of the stage of the Target, the Target's past history and current needs, and the goals and creativity of the parties. While we could devote an entire treatise to differing structures of VC investments at the various stages, we will consider a fairly typical example.

15:9. Structure of investments—Formation

Upon formation of the Target, the founders will issue stock (or equivalent interests such as limited liability company units) to themselves at very low prices. For example, two founders may initially invest $1,000 each for 1 million shares each, par value $0.0001 per share. Note that if the business is established in Delaware, you will need some par value to avoid potentially

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NVCA PitchBook, Q4 2022, p. 28.

significant franchise taxes. Therefore, a very nominal par value as suggested here will help minimize franchise taxes.

The capital structure of the Target will look like this:

Formation Type of Investment	**Holder**	**Investment**	**Shares**	**Percentage of Common**
Common	Founders	$2,000	1 million	100%
Total		$2,000	1 million	100%

15:10. Structure of investments-- Friends, family and angel investments

Once the founders have created a business plan, developed contacts and interest with customers and suppliers, and perhaps even beta tested a product and have taken other certain preliminary steps, which would attract some investment interest, they may be fortunate enough to have wealthy friends, family, or be able to find a few willing participants to invest in the Target ("angels"). The form of this investment is typically structured as a convertible bridge note, simplified agreement for equity ("SAFE"), "Keep it Simple Securities" developed by 500 angels, or common stock. See below.

If a convertible bridge note is made, it is repaid if no VC or additional source of capital is found within a certain period of time (such as six to 24 months). If a VC is found, the bridge note is converted into the same security which the VC purchases at either the VC's price or a fraction thereof. The bridge note has appeal since it avoids the need to value the business. That proverbial can is kicked down the road until the next qualified financing round. The Note is often structured so that it must convert on one of three events. If there is a "qualifying financing," i.e., a certain meaningful dollar amount is raised, it will automatically convert into that security. The conversion is typically at the lesser of a discount, i.e. 15-20% from the price per share of the security in that qualifying round or what the price would be if the valuation of the company were at a lower agreed to level (i.e. a "Valuation Cap") than the price paid by at the next round. This gives the noteholder the ability to have a discount to the next round, which in effect compensates the noteholder for the early risk. The Note may also be converted to the same new preferred security, at the option of the lender, if there is a round raising less than the amount stipulated in the qualified financing.

A Valuation Cap affirms that if the pre-money value of the next round exceeds that level, then investor in the Note will receive a requisite number of shares as if the valuation were, in fact, lower than the actual round and at the level of the Valuation Cap. This concept in effect often provides the investor with a greater discount than the discount stated if the valuation is in fact less than the Valuation Cap. For example, the Note might provide for a conversion of the principal and interest into the number of shares purchased if the pre-money valuation of the Company were the lesser of the Valuation Cap or the amount of the actual pre-money ascribed by that round (with a 20% discount). If the next round's pre-money value were $8 million and the

Valuation Cap was $10 million and there was 20% discount, the Noteholder would convert as if the pre-money were $6.4 million (i.e. $8 million discounted by 20%). If the pre-money valuation were $20 million, then the Noteholder would convert as if the pre-money were at the Valuation Cap of $10 million, so in effect would receive $10 million divided by the number of shares in turn multiplied by its principal plus interest converted.

If the Company is sold prior to the maturity of the Note or the occurrence of a conversion of the Note due to a qualified financing or a voluntary conversion, then the Note would, at the election of the lender, either be repaid with a premium (typically 50-100%) or converted into the most senior security at the price implied by the Valuation Cap.

If nothing occurs prior to maturity, then there is often the right to extend the Note or require the lender to convert the Note to a senior level of equity security, modelled after National Venture Capital Association documents or to common. This in essence eliminates the Note's status as a debt instrument since the Note is not to be repaid in cash after a period of time. Savvy investors will insist that at a minimum one of their rights should be to require repayment or else they are in effect investing in a company that can't get the requisite funding. Sometimes the Note will provide that the investor will have the choice to extend for a certain period of time while at the same increase the discount and decrease the Valuation Cap, with the theory being that the investor is taking on more risk by extending, should receive additional consideration and perhaps also encourage the Target to redouble its efforts to get financing.

One anomaly of the Note is the interplay between the discount to the next round and the liquidation preference of that next round. For example, if the Note is for $1 million and converts at a 20% discount to the next round's price which let's say is $1, the Noteholder would receive not 1 million shares but rather 1.25 million shares (i.e. $1 million worth of shares at a 20% discount to the $1 per share or $0.80 per share). This means that the Noteholder in effect receives a liquidation preference for its 1.25 million shares at $1 per share of $1,250,000 although only investing $1 million. Many Notes and liquidation preference sections of corporate charters ignore this phenomenon and permit the noteholder to enjoy this windfall. Others will provide that for purposes of the liquidation preferences, the shares held by the Noteholders will be reduced as if it had paid $1 and not $0.80 per share. More typical is that the Notes will convert to a “shadow” series of preferred, using the conversion price equal to the discount price, so that no such windfall occurs. For example, the new investors will purchase a Series A-1 with conversion price to common of $1 and the Noteholders will purchase a Series A-2 with the conversion price at $0.80. All other terms of the Series A-1 and A-2 are the same (except the dividend rate of the A-2 will similarly be reduced).

A variant of a Note is a simplified agreement for equity (“SAFE”). This document was developed over the last several years by the Y Combinator Group. The SAFE has many of the same terms and concepts as a Note as described above (discounts, Valuation Caps, automatic conversions etc.) and in many ways except very technical ones has the same functions, provisions and treatment as a Note. The main difference between the two instruments is that the SAFE avoids a few tax issues which a Note raises. For example, when a Note converts to equity, the interest is typically recognized as “phantom” income although there is no cash to pay the income tax. The Note is usually placed on the balance sheet and therefore could impact the financial picture of the Target whereas the SAFE is booked as stockholder equity due to the infusion of cash with no corresponding balance sheet liability, although the SAFE is not part of the fully diluted capital base until conversion. SAFEs are also recognized as an instrument to justify receiving an angel tax credit in States (like Illinois) that have a tax credit for debt instruments. SAFEs, however, rarely receive interest unlike a Note which must, or it is otherwise imputed.

If common stock is purchased, the first step is to value the Target. Valuation is always an art, not a science, and is especially subjective and evanescent at this point. If a $1 million value is ascribed to the Target before friends, family, and angels invest (which is called a "pre-money value") and the friends, family, and angels invest $250,000, they will collectively own 20% of the Target (i.e., $250,000 divided by the sum of $1 million pre-money value plus the $250,000 investment).

After friends, family, and angels purchase stock, the capital structure of the Target will look like this:

Capital Structure After Friends, Family and Angels Purchase Stock

Type of Investment	**Holder**	**Investment**	**Shares**	**Percentage of Common**
Common	Friends/Family/Angels	$250,000	500,000	20%
Common	Founders	$2,000	2 million	80%
Total		$252,000	2.5 million	100%

15:11. Structure of investments: early-stage venture capital

The Target may now need, for example, $1 million to beta test the software it intends to market and perhaps enhance development and start a sales effort. The founders and VC agree that the Target is now worth $4 million before the VC's investment. Therefore, the VC's $1 million investment would entitle it to 20% of the fully-diluted equity of the Target.

The structure of the VC's investment is typically in the form of convertible preferred stock. Sometimes, but rarely, you will see participating preferred stock which requires at least a one-time return and then a sharing in the upside with the common stock or a straight preferred stock which requires payment in full before common shareholders are entitled to receive any distributions plus warrants issued to the VC to purchase common shares.

Ownership of convertible preferred stock will enable the VC to have the best of both worlds. If the Target does not succeed and is liquidated or undergoes a change in control not involving an IPO (such as a sale, merger, exclusive license or other significant monetizing event), the instrument will give the VC a liquidation preference over the founders and other common shareholders. If the Target does well and is sold or merged for a substantial premium or flourishes after an IPO, then the convertible preferred stock will convert to common stock and enjoy the upside appreciation inherent in common stock.

The design of the convertible preferred stock is frequently contested during the negotiations. Design issues include the dividend rate, whether dividends accrue or need to be declared, whether dividends are payable upon a conversion or only on a liquidating event or redemption, what rights the holder of the preferred has to seats on the board of directors of the Target, whether the number of seats increases if certain milestones (financial or otherwise) fail to be met, what "protective provisions," i.e., the right to approve certain significant corporate actions such as a sale, merger, senior round of financing, dilution protection if the next or subsequent rounds of financing issue shares at a lower price per share than the adjusted rice that the VC purchased, what exit rights the holder of preferred stock has, and what the participating features are and the limits thereon. The VC's preferred stock will frequently be required to convert to common upon an IPO exceeding a certain agreed to hurdle level.

After the VC invests in preferred stock, the Target's capital structure will look like this:

Capital Structure After the VC Invests in Preferred Stock

Type of Investment	**Holder**	**Investment**	**Shares**	**Percentage of Common**
Convertible Preferred	VC	$1 million	625,000 (upon 20% conversion of preferred stock at $1.60 per share)	20%
Common	Friends/Family/Angels	$250,000	500,000	16%
Common	Founders	$2,000	2 million	64%
Total		$1,252,000	3.125 million	100%

Note that the price per share of common stock increased during each round of financing. The founders paid $0.01 per share. The friends, family, and angels paid $0.50 per share. Now the VC is paying $1.60 per share. The low valuation for the founders has enabled them to keep 64% of the Target's common stock although they invested less than one-tenth of 1% of the cash investment. This chart can be expanded as additional rounds of financing occur. The investors purchased 20% of the fully-diluted shares of the Target for $1 million which implies a $5 million value of the Target "post-money." That means the "pre-money" (i.e., pre investment) value is implied to be $4 million. Of course, value is in the eyes of the beholder, and there is no readily ascertainable market value for these private shares. Therefore, the value may not be far from bankable at that very moment.

15:12. Structure of investments: management capital

As additional rounds progress, the owners may agree that it is necessary to set aside equity to attract, incentivize, and retain the management team and other service providers such as outside advisors and directors. Option pools typically range from 10% to 25% of a Target's equity when it is at a relatively early stage. Often, as future financing is infused, the option pool may be “topped up” or increased to attract additional employees or recognize that earlier recipients' roles may have broadened or to “refresh” options that may be under water, i.e., below the strike price.

The options or stock reserved for the management team will typically dilute all owners proportionately. However, a VC will sometimes argue that it should not be diluted or at least not diluted in the same proportion as other owners. In the example below, we have assumed a valuation of $0.50 per share (or a strike price of $0.50 per share for each option) for 15% of the ownership of the Target made available to the management team. This would equate to approximately 555,000 shares for a price of $277,500. If the options dilute the existing stockholders prior to the VC's investment, the price per share will in effect be decreased on a post money basis and therefore the valuation of the Target also diminished. This is a frequent area of contention between the parties.

For example, a VC may agree to invest $1 million with a pre-money value of $8 million and an option pool of 20% post money. While the Founders might initially be proud that they extracted an $8 million pre-money valuation, that may in this circumstance be illusory. With a 20% post money pool, that in effect means that the pre-money is $6 million, not $8 million (i.e. $6 million plus the pool of 20% post money implies 25% of the pre-money value (i.e. 2 million on 6 million plus the 2 million) plus the $1 million of VC funds for a total post money value of $10 million with the options.

The Founders may cry foul. They might claim they don't need a 20% pool, only a 10% pool. They might claim that there is no certainty that all options will, in fact, be granted and if they are, that they may or may not be fully vested at the time of change of control. They may suggest that the denominator of fully-diluted shares should increase by any convertible notes and SAFEs, mitigating the impact of the dilution. Also, the company has cash in the bank (hopefully) from the Notes and should get credit for that.

VCs might have to respect the counterargument on the need for the 20% pool at this point and reduce the pool to some level that is more probable to actually be granted within the next 12-18 months. This would minimize the dilution to the founders which the pools cause. VCs will not embrace the argument that the Notes should not be in the denominator since, while that may be true in theory, in reality much of the cash from the Notes was most likely already spent and probably already used to generate the pre-money value in the first place.

After issuing options to the management team and their full exercise of the options, the

Target's capital structure will look like this:

Capital Structure After the VC Invests in Preferred Stock

Type of Investment	**Holder**	**Investment**	**Shares**	**Percentage of Common**
Convertible Preferred	VC	$1 million	625,000 (upon conversion to common stock) at $1.60 per share	17%
Common	Management/Employee Pool	$277,500	555,555	15%
Common	Friends/Family/Angels	$250,000	500,000	14%
Common	Founders	$2,000	2 million	54%
Total		$1,529,500	3,680,555	100%

15:13. Obligation to close

The right of a VC to be relieved of its obligation to close has become a significant issue in recent years. The issue is more prevalent in PE transactions due to the sometimes considerable time lag between signing documents and closing (due to regulatory approvals, obtaining bank financing, third party consents and other delays) and less prevalent in VC deals since many are signed and closed simultaneously. The most hotly contested issue in recent years, which has excused closing due to the occurrence of a "material adverse change" in the Target, is often not present in early stage companies because the investment is not typically predicated on the financial condition of the Target but rather on the specific measurable milestones or events. Further, most VC transactions sign and close at the same time, so formal contractual conditions to closing are handled prior to the parties' signing and closing.

IV. Valuation of the Business and Ownership Percentages

15:14. Basic approaches to valuation

Valuation of the Target is key to determining the ownership interest that the VC's investment will purchase and the range of nonmonetary rights the VC may seek to obtain. At the risk of oversimplifying three university courses on finance, valuation will be made using one or more of the following basic approaches:

- *Comparable Businesses.* The first basic approach to valuation looks at what businesses comparable to the Target have sold for or been valued at. In the jargon of the particular industry, the sales price may be a multiple of earnings, cash flow (i.e., earnings after adding back interest, taxes, and depreciation expense and amortization charges ("EBITDA")), modified EBITDA (by providing for changes in working capital, adjusting for capital spending, and taking out or adding back extraordinary items or costs which should be normalized), multiple of book value or revenues, multiple of annual recurring revenues ("ARR"), or some other standard formula. At the VC stage, however, these metrics are usually not present since EBITDA is a far-off dream. At best, a metric may be a multiple of revenues. For example, software as a service ("SaaS") businesses frequently trade on a multiple of recurring revenues or ARR basis. Depending on the rate of growth and potential size of the total addressable market, this could range from five to 30 times ARR. Prior to the valuation recalibration in the VC world starting in mid to late 2022, the ARR range could be in the 20-30 multiple depending on growth rates and gross margins. In mid-2023, however, valuation compression to the lower end is the norm. This valuation reduction is not just a reflection of the relative bargaining power of those with cash to invest or a reflection of a less optimistic view of the short-term prospects for the economy and growth prospects. Multiple compression also reflects two basic laws of economics- first, whereby if interest rates increase, so do valuations discount rates, and conversely so do exit multiples decrease, and second, multiples are in part a function of risk, certainty and growth prospects so if trying economic conditions compromise those key variables, ensuing pressure on multiples and hence valuation will decrease.

- *Replacement Cost.* The second basic approach to valuation looks at what it would cost to replace the assets and going concern value of the Target's business. This replacement cost method addresses the perennial issue of "buy versus build." The prospective investor adds up the sum of all of the parts--the buildings, distribution channels, reserves, brand name recognition, etc.--to gauge what it would actually cost to duplicate the business. Again, this metric is difficult, if not impossible, to gauge accurately, particularly in an early stage investment. Some investors will ask themselves whether it makes sense to purchase a software company for a certain value when they feel they can develop the software for less than that in a reasonable period of time. The frictional cost of taking out a competitor and the certainty of the time, cost and success of development may at time, however, be overlooked.
- *Discounted Cash Flow/Internal Rate of Return.* The third basic approach to valuation looks to the future of the business, unlike the comparable business approach, which looks at the past, and the replacement value approach, which looks at the present. The third basic approach attempts to estimate the future cash flow streams of the business, including the cash from an anticipated sale sometime in the future, and discount those cash flow streams back to the present by using a reasonable discount or "hurdle" rate. The discount rate will be higher based upon perceived risk and uncertainty that the projected results will be achieved. If the amount equal to the proposed investment less the discounted present value of the cash flow stream exceeds zero, the investment makes sense. Given the highly speculative nature of what free cash flow is likely to be many years out in the future and the appropriate discount rate, this approach is of questionable utility in a VC-backed company as well.

The reader can now appreciate that valuation of a VC-backed company is probably more of an art than a science. VCs will often intuit that their investment will be binary; it will either generate a multiple return or be worth nothing. Therefore, the real valuation debate is as much visceral as analytical--what do the VC's instincts tell it that an early-stage company should be worth and how much ownership does it feel it needs?

VCs typically take two approaches to determining what percentage of the Target their investment will buy. The “inside out” approach determines what the Target is worth and what the investment will buy. For example, if the business is worth $1 million and $1 million of capital is needed, then the VC will seek a 50% ownership interest.

More typically, particularly in early stage investments, the VC adopts the “outside in” approach. It applies its desired return on investment in order to value the Target. For example, if the Target is worth $1 million today, the VC desires a 35% internal rate of return on its $1 million investment, and believes the equity of the Target will be worth $5 million in five years, then the VC must own 56% of the common stock to achieve that desired return.

15:15. Determination of ownership percentage: vesting

A VC's ownership interest may also functionally increase if founders and employees' interests are contingent on or subject to reduction due to concepts of vesting.

Options granted to the Target's management employees typically only vest over time and sometimes based on performance. The purpose of vesting is to tie the management team to the business for a period of time and to assure that managers do not reap a windfall if they have not put in the required time or effort. Further, since ownership in the business is needed to attract, retain, and motivate management, vesting serves as a basis for recovering some ownership interests from departed personnel. Those recovered interests, in turn, can be used to attract and compensate replacement management personnel.

A fairly common vesting schedule may be over three to four years. TA typical schedule is that there is no vesting for the first year (so called “cliff” vesting) and then on the first anniversary, the options would be 25% vesting. The balance of the 75% is typically vested over 3 years, either in annual, quarterly or monthly tranches. If the bulk of the hard work and effort is in the early stages (e.g., if software needs to be developed over the first couple of years before operations can begin), the vesting may be front-loaded. Conversely, if the VC believes that management's full attention is needed over the entire four years, it may backload or cliff base the vesting, so that, in the most egregious case, if a manager leaves the Target on the third year and 364th day, the manager's vesting percentage would be zero. Many vesting schedules are “cliff” (i.e. zero) for the first year and then vest over the remaining three years either annually but typically equal quarterly or monthly tranches.

The vesting schedule typically accelerates upon the sale or other change of control of the Target or its business, termination of a manager's employment with the Target without cause, good reason and death or permanent disability. Sometimes the acceleration rate is 100%, and sometimes it is a smaller percentage. Conversely, the vesting percentage is typically zero if a manager's employment with the Target is terminated for cause or the manager breaches a noncompetition or confidentiality covenant. Sometimes an employee will extract a concession that if they are fired without cause or terminated with “good reason” and the company is subsequently sold within the next six to twelve months, and the sale proceeds would have provided more money to the employee, then the employee will receive that differential amount. This approach keeps an unscrupulous employer from terminating an employee simply to deprive them of the increase. The converse is true. The VC backed employer will sometimes require a recapture provision. This clause deals with the situation of an employee leaving without cause, receiving a nice payout on option exercise, and then it is later determined that grounds for a cause termination in fact did exist, but the Target was unaware of the circumstances until after termination and payment of the option value or, even if no grounds for termination existed. The clause also handles the situation where the former employee subsequently breaches a restrictive covenant (such as by using or disclosing confidential information, competing, or soliciting). In those circumstances, the former employee is required to return, often with interest, the ill-gotten gains from the options to which she was not entitled.

You will also sometimes see a “double” trigger vesting. This would require an acceleration of vesting on a change of control to occur if two conditions are met--there are both a change of control and also a requirement that if the employee is requested by the acquirer, she will remain employed by the acquirer for a transitionary period post-closing, say six to 12 months, on comparable terms and conditions (except perhaps title and reporting responsibilities) to assure a smooth transition for the buyer. Many of these clauses go a step further and say that if the second condition is met, i.e., the employee stays employed by the employer for at least that 6-12 month period, then no benefit is earned since the employee has a job and presumably has received new grants from the new employer. Many senior executive resist this strenuously given the perceived unfairness of working hard and then having the appreciation evaporate just based on future employment where the new options have to vest all over. Employers, on the other hand, feel this is fair since acceleration of vesting does not necessarily reflect the value and contribution of the employee's efforts.

15:16. Determination of ownership percentage: clawbacks for founders

As the earlier charts demonstrate, founders typically initially own a proportionately large percentage of the Target's equity relative to the total capital invested. As a result, VCs will often insist on reducing founder equity stakes based on either time-based vesting concepts similar to those discussed in the preceding section or based upon the failure to attain certain performance milestones. For example, if a Founder has 1000 shares, the VC may agree to consider 1/3 of them “vested” and the balance to vest over 3 years in 36 equal monthly installments with a double trigger acceleration. The logic is simple--if a VC is in effect investing in a founder, and that founder leaves within a short period, the underlying premise of the VC investment is undermined and a revaluation of the Target is only fair. Similarly, if a VC valued the Target in part upon the likely attainment of an FDA license and that license was not issued at the projected time, then the financial assumptions underlying the investment are askew and justify recalibration. In many cases, the parties will compromise and half vest the founders' stock and subject the balance of the founder shares to vesting is as discussed above. Many founders feel that this clawback and re-vesting concept puts at risk the substantial lot of their hard work, sacrifice, and energy over the past many years and are concerned that they could see a significant diminution in value if they are forced out. VCs remind them that they do not control the board and it is also likely for the best. Since that often does not assuage founder concerns of being unwillingly forced to relinquish previously earned shares for no reason except losing the board's confidence, parties will often compromise and only subject the shares to forfeiture if the founder leaves without "good reason" before being fully vested or is terminated for "cause." The founder can then rest assured that if she is terminated without cause or leaves for "good reason," that she will continue to vest in or be fully vested in her shares.

15:17. Determination of ownership percentage: down rounds

If there is one certainty in VC investments (besides the certainty that there is uncertainty) it is that additional capital will be needed to continue the Target's growth. While everyone hopes and expects that the Target's price per share will rise inexorably, that obviously does not always occur. Market timing, delays in approvals, delays in finishing code, general market driven valuation compression, sales cycle taking longer than expected, ramping up by spending more on marketing and sales than previously projected, or just unfortunate budgeting all justify lower valuations for the next round of VC financing.

In many cases, the Target has little or no choice but to accept the lower valuations and hope that the VC does not try to take undue advantage of its increased negotiating power. In many cases, the VC actually wants to soften the dilution which key employees will suffer from the impact of a down round.

To minimize the impact of a down round on key employees, the VC may permit the Target to grant options to key executives at the lower price, a so-called "top up". A similar technique would be to permit executives to purchase preferred stock, or to give them options to buy preferred stock, at the VC's down round price. These two approaches dilute the interests of earlier round investors, including other founders, but they soften the blow to the key members of the management team and therefore may keep them motivated.

Another way in which a Target can seek to mitigate the effects of a down round is to request the right to redeem the stock purchased by the VC in the down round at some future date. While the VC may argue that treating its investment, in effect, like a loan does not adequately compensate it for its risk and cost of capital, the Target will argue that this is a fair approach to prevent the VC from unfairly exploiting its advantage. Further, boards will frequently award management incentive plans to provide management teams a pool of funds off the top of any sale or based on attainment of certain financial and/or time metrics. This is usually prevalent when management equity might not be in the money or particularly robust, yet their staying through a sale and being motivated is perceived to be warranted. Finally, management teams are often conferred retention or stay bonuses to entice them to help sell the company and remain with the buyer, if requested, for some time after the closing.

15:18. Determination of ownership percentage down rounds: fiduciary duties

A director of a Target can face potentially serious conflicts of interest in deciding whether to issue a new round of stock if the price per share is less than the price paid for stock in prior rounds or even if the price per share is higher but not measurably so. This potential conflict is particularly acute in the situation of a director appointed to protect the interests of a VC. That director may have a conflict between his or her fiduciary duties to both the Target that cannot be waived and its shareholders generally on the one hand and the particular interests of the VC on the other hand. Issuing new stock at a price lower than that paid by the VC may harm the interests of the VC, but issuing such stock may be in the best interests of the Target's shareholders generally. In theory, this issue should apply at any valuation level; the potential for conflicts abound any time a valuation, even a higher valuation, is set. Further, if the VC also invests in the lower priced round, it has reduced its overall cost basis in the Target's stock and picked up more shares cheaper (assuming it is not throwing good money after bad).

Short of VC-appointed directors recusing themselves and not participating in the decision to issue stock in a down round or not participating in the decision about the price of that stock, one or more of several precautions should be taken to limit the potential exposure of directors to liability for breach of fiduciary duties:

- Establish an independent committee of the board of directors that does not include the VC directors to evaluate the terms of the proposed financing and negotiate the terms with the new investors;
- Get a 409A valuation or even retain an independent valuation company to provide a fairness opinion or appraisal of the value of the stock of the Target;
- Seek to sell at least part of the new stock to a third party who is not already a shareholder of the Target in order to show the fairness of the proposed price;
- Give the existing shareholders of the Target preemptive rights to purchase the new stock in order to protect themselves against dilution resulting from the issuance of the new stock;
- Seek the prior approval of the non-VC shareholders of the Target, and offer them additional options or other incentives if necessary to secure their approval (recognizing the risk that this could cause the minority to try to use its perceived leverage to extract concessions from the majority); or
- Award minority shareholders additional options or provide other incentives to entice them to approve the transaction.

The directors should, in any case, fully and carefully discuss all of their options, including a merger, sale or licensing of assets, as well new financing. Any interested director should fully disclose his or her conflict, and complete and detailed minutes of directors meetings and disclosures are critical.

These issues, while prevalent in a down round context, also come into play in a change of control scenario. The classic situation, litigated for years in the Delaware case of *In re Trados,*[1] involved conflict at the board between the preferred stockholders desiring to sell the company to get their money out notwithstanding the absence of any residual proceeds to the common stockholders. The common stockholders, on the other hand, both having nothing to lose by voting against the transaction and also believing the longer term value of the company was not being realized from the sale, challenged the conduct of the preferred directors as a violation of their fiduciary duties. The court ultimately found that this was a question of fact and not

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In re Trados Inc. Shareholder Litigation, 73 A.3d 17 (Del. Ch. 2013).

automatically dispositive one way or the other as a per se breach or not. Some of the suggestions above assist in addressing the fiduciary duty challenges and reduce the chances of successful litigation against the preferred directors.

V. Documentation

15:19. In general

Documentation of a venture capital transaction has nuances and dimensions far beyond the scope of this chapter. Selected major issues that are often confronted in these documents are discussed in other sections of this Chapter.

The basic documents and their purposes are set forth below. Over the years, various routinely used concepts have become embodied in documents for SAFE investors, Seed Stage investments and Series A and later stage investments as released by the National Venture Capital Association ("NVCA"). While the NVCA model forms are more robust and detailed than the standard Seed Round forms, many of the same provisions are covered in both, albeit with a lower level of thoroughness and investor protection. This discussion will only highlight some of these standard documents. Like any standard documents, there are refinements and distinctions in every transaction, although 90% of the forms are typically followed.

While each transaction is different, many of the same concepts and approaches appear in most deals. The NVCA provides a terrific service by reducing the need to unnecessarily re-invent the wheel for every deal. Standardization of documents embraced by an industry greatly facilitates the transaction and reduces unnecessary cost and friction. At the same time, the forms recognize considerable nuances and different approaches in different circumstances and provide various suggested nuances. These documents tend to reflect industry norms, be fair and middle of the road, present a range of possible options, include footnotes with explanatory comments and alternatives (which is great education for us all), attempt to eliminate or mitigate unenforceable provisions, and promote consistency among transactions. The latter point is particularly critical as VC backed companies often have multiple rounds of financing, many of which are provided by different professional VC funds. These normalized documents facilitate the layering on of new rounds of capital on forms that look familiar and normal, hoping to avoid the cost and time of excessive renegotiation of customary provisions.

15:20. Term sheet

The term sheet, which is usually nonbinding (except for certain provisions discussed below), sets forth the salient details of a VC's investment and the related terms and conditions. The term sheet sets forth the amount of the investment, price per share, design of the equity interest that the VC will obtain (including such items as conversion rights and obligations, participating features, coupon rate on the dividend and whether the accrued coupon is forgiven or not upon conversion, dilution protection, and preemptive rights), right to approve certain Target actions, rights to redeem the investment, registration rights, rights to participate on the board of directors of the Target, drag and tag-along rights and rights of first refusal, and conditions to closing such as the execution of employment, noncompetition and confidentiality agreements.

There are two major benefits of the term sheet for the VC. First, it avoids needless and protracted negotiations of the documentation if the Target is not amenable to the fundamental terms. The term sheet can also allude to the use of the NVCA standardized documents for use in the transaction as reflected by the specific terms in the term sheet. Second, the term sheet requires the Target to make binding commitments on some matters relating to negotiation of the VC's investment. For example, the term sheet frequently gives the VC and its advisors the right, for some period of time, to have the exclusive right to have access to the Target's books, records, properties, customers, suppliers, and personnel in order to conduct a due diligence investigation. The term sheet may also commit the Target not to solicit, entertain, or accept offers from other investors or negotiate with other investors for a period of time. In addition, the term sheet may commit the Target to cover some of the VC's expenses, even if the transaction is not finalized. Founders may strive to avoid these binding provisions, especially if there is a great deal of enthusiasm from other potential investor groups. If the exclusivity is required, founders should obviously try to limit the period as much as possible and end it if the VC tries to change the pricing or other material terms.

15:21. Stock purchase agreement

The stock (or sometimes LLC unit) purchase agreement is the definitive binding document that sets forth the terms and conditions upon which the VC will invest in the Target. The purchase agreement implements the term sheet and contains the following terms, among others:

- The purchase price for the sale of shares to the VC;
- The closing date;
- Representations and warranties of the Target, such as its due incorporation and authorization to enter into the transaction, title to its assets, the condition of the assets, amount and nature of its liabilities, rights to its intellectual property, its financial condition, absence of litigation against it, and its compliance with laws;
- Representations and warranties of the VC to enable the Target to avail itself of applicable exemptions from the securities laws;
- Conditions to closing, such as the execution of the remainder of the documents discussed below and sometimes delivery of a legal opinion from the Target's counsel, authorizing resolutions, and various other items; and
- Payment of legal fees for the VC.

Interestingly, the NVCA model Stock Purchase Agreement does not have any indemnification provision for breaches of and damages arising from the Target's representations and warranties. In contrast, that article is frequently hotly contested in merger and acquisition transactions. Perhaps a reason for the absence of indemnification provisions in the model NVCA form of Stock Purchase Agreement is that the practical remedy for the Target's breach of representations and warranties is often meaningless, especially for a Target in the early stage, since the Target may not have the resources to honor the indemnification obligation. A well-crafted document could seek indemnification from founders in the event of fraud or willful misrepresentation, but this concept is rarely seen. Other remedies in situations involving significant breaches could be to enable the VC to elect a sufficient number of directors to gain control of the board of directors of the Target, to provide for issuance of additional shares of stock to the VC in lieu of a cash indemnity, or to cause the Target to redeem the VC's shares at cost.

Recent recommended changes to the NVCA form Stock Purchase Agreement were modest. For example, there are additional drafting options for milestone payments, whether in life sciences transactions or otherwise. Some of the customized suggestions in the footnotes involve means of determining if the milestones are in fact met.

Other fairly recent changes involve the “bad actor” representation. There is typically a representation by the Company and each stock purchaser that none of its key persons are “bad actors” under Rule 506(d) of Reg. D and thus would disqualify the Reg. D offering. This was moved to the Voting Agreement to provide all stockholders, not just the purchasers in this round, with the benefit of the representation. A number of representations and warranties were added from the Company for VC investments in life sciences companies. Perhaps the most significant recent update to the NVCA forms, not just of the Stock Purchase Agreement but the other main forms (so I will not repeat it in the discussion infra), is to add a new alternative dispute resolution mechanism. This provision enables parties to select the Delaware Rapid Arbitration Act (“DRAA”) as a means to resolve disputes. These additions are quite extensive and include a set of lengthy footnotes to understand the DRAA and provide different drafting options.

Given the increasing rise in tensions over the past few years with China and other potentially unreliable countries, parties have given more scrutiny to representations and warranties in the Stock Purchase Agreement addressing the Foreign Corrupt Practices Act (“FCPA”). FCPA deals with disclosures on the Target's bribing foreign government officials. This fact situation is not common in early stage venture deals. An increasing occurrence, however, is investments in US Targets from foreign nations (through their sovereign wealth funds) or individual persons, companies or funds. The Committee on Foreign Investment in the United States (“CFIUS”) is therefore becoming more and more prevalent in both the representations and warranties in the Stock Purchase Agreement and Investors Rights Agreement (see infra). The breadth of CFIUS is beyond the scope of this Chapter. Some basics are important as they are becoming increasingly relevant, and transactions are becoming more and more subject to CFIUS scrutiny.

CFIUS is empowered to conduct a national security review of a “covered transaction” which is a proposed or pending “transaction” which could result in “control” of a “US business” by a foreign person. The notion of “control” and “covered transactions” is obtuse and not well defined. They are generally thought to mean whether the Target has contracts with US government agencies possessing national security responsibilities or performs (or did perform) under any classified contracts, or deals in “critical technologies” or products such as commodities, software or technology controlled under US export control laws, or is near sensitive government facilities (e.g. military bases, national laboratories etc.) or whether the transaction would result in foreign control over physical or virtual “critical infrastructure.” While this all sounds vague and amorphous, more Target counsel are resisting providing representations regarding CFIUS compliance, suggesting that it will take too much time and cost to confirm that the Targets products involve “critical technologies.” In any event, if this is a close call, or a clear call that CFIUS compliance is required, many steps to receive clearance and even denial or reduction of the investment or required divestitures obviously greatly change the risk profile of the investment.

15:22. Investor rights agreement

The Target typically agrees to three basic commitments in an investor rights agreement ("IRA"). First, the Target provides registration rights to the VC. The VC, together with minimum threshold of holders of preferred stock (typically 50% of the shares) and minimum gross proceeds to the sellers (typically $3-5 million), will often receive at least one demand registration right (right to require registration) either at a fixed period of time or within a fixed period of time after the Target's IPO. Minimum thresholds of amounts to be registered are sometimes negotiated. There are often restrictions and limitations based on a variety of facts and circumstances. There are typically unlimited number of S-3 registration rights once the Target has filed its S-1 registration, with some limitations. Piggyback rights, i.e., the right to sell in connection with an IPO or a secondary, are normal rights as well. While these provisions are normal, the reality is that very few Targets actually go public. Even if they do, the IPO underwriters will often have their own ideas about which provisions are reasonable in light of the then current market conditions and particularities of the Target, so these agreements are often renegotiated in an offering.

Second, the Target may affirmatively covenant to continue to do certain things (such as complying with laws, adhering to budgets, and a whole litany of items) and negatively covenant not to do certain things (such as not sell or merge its business, increase executive compensation over a certain threshold, and a whole litany of items). Other covenants include giving certain investors' inspection and/or observer rights, and for earlier stage companies, a litany of "good housekeeping" promises to bring best practices to the company's governance. These include adoption of policies for cybersecurity, anti-harassment and discrimination, QSBS (see infra) compliance, adoption of Carta or another stock record keeping software and sometimes the right for an investor counsel to participate in the sale process with the fees paid for by the company with a cap. Investors should also insist on a provision where the company acknowledges the investor is a professional investor, may have conflicts including investments in competitive companies or portions of the supply chain, and all such conflicts are acknowledged and waived. This waiver is critical to insulate the VC from charges of breach of fiduciary duty.

Third, the Target will grant preemptive rights to the VCs and other preferred holders to permit them to subscribe to newly issued equity to avoid share count dilution. Sometimes you will see a threshold ownership level below which these rights are extinguished. Other times you will see a "use it or lose it" provision where shareholders lose the right if they do not exercise on one or more occasion. Occasionally the provision will allow one or more investors to advance the funds to the company in an emergency situation, subject to other investors' right to catch up with their share.

Further, you occasionally see a "pay to play" provision, although the numbers in 2024 and early 2025 declined somewhat over 2023. This provision imposes on the VC and other preferred investors sometimes draconian consequences for failing to exercise these rights. For example, of an investor does not subscribe to purchase its pro rata share in the new offering, its preferred shares could become non-voting, or convert to common or a junior preferred security.

These clauses are becoming more and more prevalent given the greater leverage of newer rounds of investors in down markets. Pay to play provisions of course are double-edged. While the company or an investor may ask for the provision to assure that other members of the investment group continue to invest in future rounds, the existence of these provisions could backfire. They could scare off new investors from wanting to invest. They could also impact the VC who insisted on the provision in the initial round, only to suffer its adverse consequences in the future if it fails to continue funding its pro rata share. Often you will see compromises regarding a sunset on the effectiveness of the provision and sometimes on the percentage of shares that an investor could have subject to the provision.

An offshoot to pay to play provisions that have been surfacing since the softness in the VC funding markets has been "pullup" provisions. These clauses allow any stockholder who subscribes to its full pro rata share in a play to play offering to have the security that it owns "pulled up" or made the same as the new security. This is particularly beneficial to earlier stage investors whose shares rank behind many other senior layers of shares to have their shares gain seniority and priority as a recompense for subscribing.

An IRA will often set forth special voting rights for one or more of the Board members designated by the VC and other preferred stockholders. These rights may include budgets or budgetary components, issuance of stock options, incurrence of debt and other structural issues.

Finally, the Target will usually always agree to give certain information rights to the VC and often others who subscribe to and maintain ownership of a minimum amount of shares. Information rights may include the provision of interim and year-end financial statements, notices of lawsuits, and notices of defaults or other major items.

This agreement is almost always terminated upon a conversion of all of the VC's stock to common, or a sale or IPO. In some cases, the Target may seek to reduce or terminate its obligation upon the VC's reduction of its ownership stake in the Target below an agreed-to level.

Recent recommended changes to the NVCA form of Investor Rights Agreement include clarifying the definition of Series A Director to refer to a director elected solely and exclusively by the Series A preferred stockholders, acting as a separate class. Termination of the registration rights provision upon availability of Rule 144 was made clear that this was only after an IPO. There is often a covenant that the Company use some sort of reasonably commercial efforts to obtain directors and officers insurance coverage within 90 to 120 days after the round. This standard was deleted and therefore unqualified. The amount of recommended coverage was also increased from $2 million to $3 million. Further, bracketed language was added to consider allowing the Series A Director to approve the Company's next year's budget or business plan. Other technical provisions were added dealing with amendments and third-party beneficiaries.

As a follow up to the increased sensitivity to foreign investment in critical technologies owned by a US Target discussed in the Chapter above involving representations and warranties involving CFIUS, IRAs increasingly contain covenants and agreements dealing with the Target's compliance with Section 721 of the Defense Procurement Act ("DPA") if the DPA is triggered by virtue of the application of CFIUS. The covenant in the IRA will forbid, absent Board approval, the Target granting to any “Foreign Person” (foreign citizen, sovereign wealth fund, business, individual etc., similar to the scope under CFIUS) any “DPA Triggering Rights” or voting equity interest exceeding 9.9% of the Target. “DPA Triggering Rights” means (i) “control” (defined in the DPA), (ii) access to any “material non-public technical information” which the Target possesses, (iii) membership on the Board or observer rights and (iv) any involvement (except through voting the shares) regarding the Target's use, development, acquisition, safekeeping or release of “sensitive personal data” of U.S. citizens maintained or collected by the Target or the management, operations, manufacture or supply of “covered investment critical infrastructure” (as such quoted terms are defined in the DPA).

15:23. Amended governing documents

The Target's certificate or articles of incorporation or operating agreement will need to be amended at the closing of the VC's investment. The amendment will typically set forth, among other things, the design of the preferred security the VC is purchasing. For example, is the preferred stock participating or convertible? If it is participating, is there a cap on the participation features after which it becomes automatically convertible? For example, if the preferred receives two or three times its investment on liquidation and then share in the upside with the common shares, would the participation feature be eliminated and simply become a convertible instrument on the belief that this is an ample enough return. Certain nuances in the design of the preferred security are discussed in subsequent Chapters.

The provision of dividends is also set forth in the charter, including whether or not and how often the dividend rate is compounded. A frequent issue of discussion is whether the dividend automatically accrues, whether or not any action of the board is required, or whether an action of the Board is required for issuance. Obviously, the VC prefers the former. Upon a change of control or other liquidating event, discussion often ensues about whether the accrued dividend is forgiven (again, on the enough is enough theory) or is paid in cash or actually purchases new shares and thus shares in the upside. VCs obviously prefer the latter since the dividend yield is part of their investment. The Founders argue that the yield is just icing on the cake and should only be paid in a true liquidation as downside protection (although this could be theoretical if the company runs out of money).

In the event that a mandatory milestone payment is not made (such as in a life sciences investment transaction) by the investor, the revised Model NVCA form of Certificate of Incorporation provides as a remedy for a mandatory conversion of the preferred stock held by the defaulting investor to common stock, typically at a discount to further penalize the defaulting investor (see further discussion in the Pay to Play section below). The Certificate also contains a covenant from the investors that they will not convert immediately prior to or in anticipation of the default to avoid the penalty of the default ratio. Conversely, if the Target fails to meet its performance milestones, the charter will often readjust and lower the price per share to provide the VC with more shares as compensation for this milestone miss.

Other provisions include strengthened indemnification provisions, provisions relating to the election of the Target's board of directors, the VC's rights to approve or reject certain fundamental transactions, and dilution protection in case there is a down round. These and others are all discussed infra.

Despite Delaware law requirement that the designations, privileges and rights of preferred shares be set forth in the charter, many charters often defer key items to other documents which are discussed in this Chapter. The revised NVCA form Charter condones this practice.

Other recent NVCA form changes are very technical and ministerial. Perhaps the most substantive is to reflect that in the event of a company default of its redemption obligations, high interest rates may accrue to incentivize the company to honor its commitment and compensate the holder for its risk in not receiving timely payment (see discussion infra on redemption).

15:24. Voting Agreement and Co-Sale and Right of First Refusal agreement

The existing Target equity holders, together with the VC, will often enter into a Voting, Co-Sale and Right of First Refusal or similar agreements to address means of preserving the unity and harmonious ownership and management of the Target. These issues include:

- The right of any holder to sell its securities and the rights of the other owners upon such sale to either purchase such securities or sell theirs at the same price. That being said, the VCs shares are not usually subject to a right of first refusal since this is their business and they do not want to encumber or diminish the marketability of their shares with this restriction. If there are other VCs who have participated with them, they might have a side agreement giving the other VCs the right of first refusal or negotiation or the right to tag along. In the NVCA form of Co-Sale and Right of First Refusal Agreement, the Company typically has the first right and then the VCs have the second right, with the right to buy even more if one or more shareholders declines to exercise their rights (i.e., a right of oversubscription) to purchase the shares of the Founders and other non-VC shareholders. Some Co-Sale and right of First Refusal Agreements provide only to the VCs, and not to earlier preferred investors or new preferred investors who purchased below a specified sum of new shares, the secondary right. Targets will try to insert clauses saying that if all of the shares to be sold by a founder are not purchased by the Target or other investors, then the entire right to repurchase is forfeited and the founder may freely sell in accordance with the terms. Investors will resist this provision since it puts a gun to their heads to purchase more than their pro rata share of the shares. Founders rejoin that such a provision is necessary since the would-be buyer has asked to buy the specific quantum of shares being offered and not less.
- VCs will often put a time period before which the Founder may not sell their shares (except to family members) to assure the parties stay together for some period of time. If a sale of shares does occur and the right of first refusal not exercised, the documents usually provide that the other shareholders, or at least the VCs may sell their shares (i.e. "tag-along") on the same terms and conditions as if the company were actually being sold and the proceeds distributed in accordance with the charter. In that case, it is possible that the VCs will actually receive proceeds from the sale and the Founder would not and that would in effect negate the sale since the Founder would not have any motivation to consummate a sale at that point.
- A Restricted Stock or similar agreement will provide the Company with the right to buy back the founders' or key managers' holdings upon their departure from active roles in the Target (perhaps at a lower price and longer payment terms if the departure is for cause or

the departure is voluntary but prior to a certain agreed-upon date). These rights and different pricing and other nuances are discussed later in the Chapter.

• The NVCA form of Voting Agreement and a typical operating agreement will provide for the all owners to elect various representatives of the VC and management personnel to the Target's board of directors. Often, at least one independent director is appointed as well. Typically, the Founders and common stockholders will elect their slate, the VCs and the other preferred holders will select their slate, and then the two (or some permutation thereof) will select the independent(s). Often, the CEO is designated to be on the board or be allocated one of the common seats. Recent footnote additions to the NVCA model Voting Agreement suggest clarifying that the right of the Founders to elect the director are restricted to the Founders still active in the business. That is an excellent suggestion, avoiding tracking down and bringing up to speed an uniformed Founder, particularly one who may not have departed willingly or under the best of terms.

• The right of a supermajority of directors, or of any one director (normally a VC director), to block the Target's taking certain enumerated actions, such as a sale, merger, or issuance of new stock is typically provided in the Investor Rights Agreement as noted in the prior Chapter. In light of Trados and other cases, provisions allowing a class of directors to approve certain actions is less and less common due to concern regarding their conflicts of interest and the fact that they often have the same protections built into the charter, where their voting often is not subject to fiduciary duties, although a recent prominent case in Delaware has called that statement into question.

The same fiduciary concerns of directors might also now apply to minority stockholders if those minority stockholders, by virtue of their contractual rights, are in fact "controlling" stockholders. In *Basho Technologies Holdco B, LLC et al v. Georgetown Basho Investors, LLC et al*, the Delaware Court of Chancery (the Court") ruled in July 2018 that Georgetown Basho Investors, LLC (the "Defendants"), minority shareholders in Basho Technologies, Inc. ("Basho"), owed and breached its fiduciary duty to the other shareholders.[1]

In that case, the Defendants made an investment in Basho, which entitled Defendants to, among other things, veto of all of Basho's future financing transactions.[2] When Basho later required funding, the Defendants utilized its veto rights and blocked three proposed financing transactions. Defendants flaunted these rights, even stating in an email that "we control Basho."[3] Eventually, Basho was forced to accept financing from the Defendants. The terms of such financing were very lucrative to Defendants, such as a liquidation preference equal to three times

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Basho Technologies Holdco B, LLC v. Georgetown Basho Investors, LLC, 2018 WL 3326693 (Del. Ch. 2018), aff'd, 221 A.3d 100 (Del. 2019).

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2018 WL 3326693 at *1.

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2018 WL 3326693 at *6.

invested capital, the ability to convert preferred stock into common stock that carried 10 votes per share and the right to designate five of the seven members of the board.[4]

Other stockholders sued Defendants claiming that, as controlling stockholders, the terms Defendants extracted were so unfair that they violated fiduciary duties. The Court agreed with the plaintiffs, finding that the Defendants, as minority but nonetheless controlling stockholders of Basho, owed a fiduciary duty to the other stockholders because of its negotiated veto power over certain key corporate actions.

The result in *Basho* is unsettling as it puts into question the very construct of typical venture capital transactions, and many other private investment transactions, where a minority group has "protective provisions" or blocking or veto rights over certain major decisions. If the investors have to look over their shoulder and assess their decisions through the prism of the entity and its other owners and not their own self-interest, risk underlying any investment would be heightened.

Perhaps the case will be reversed on appeal or will be viewed as aberrational due to the imprudent if not outrageous conduct of the investor group. For example, the Court noted that when another investment group made a stronger offer, the Defendants intentionally made misleading and contradictory statements to forestall consideration of that bid. Defendants also acted and asserted themselves as if they were in fact in control of Basho. All these facts, together with the contractual veto rights, created a fiduciary duty according to the Court. Defendants breached that duty by constructing a process for obtaining financing which effectively stacked the deck so they were the only real option and then larded themselves with overly generous terms. The Court eventually ordered the Defendants to pay over $20 million. The ruling serves as a cautionary tale for minority stockholders who effectively control individual transactions of a corporation and the duties they may inadvertently create and violate as a result.

- The Voting Agreement also confers a right to a class of persons, often the Board and a sizeable portion of the preferred shares, to require all stockholders to approve a change in control transaction and waive all objections, appraisal and dissenters and similar rights to object. Conditions to these "drag-along" provisions include that the stockholders receive the same consideration or allocation of consideration in the transaction in accordance with the terms of the incorporation documents, that no non-compete and non-solicitation agreements are imposed on parties, that no specific representations and warranties are imposed on individuals dealing with the company but only with regard to their title to their shares and power to enter into the transaction. The updates to the model NVCA form of Voting Agreement contain a footnote extolling the importance of an express waiver of appraisal and dissenters' rights given recent Delaware judicial opinions. Debate still exists regarding the viability of waiving fiduciary duty claims in advance, especially in connection with the sale of the company inherent in a drag-along clause. While VCs might feel that an advanced waiver of the fiduciary duty clearly evinces stockholders' intent and is an inducement to

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2018 WL 3326693 at *17.

entering into the investment, the junior preferred and common stockholders might feel that there nonetheless remains an implied duty notwithstanding the express waiver.

15:25. Other documentation

Other documentation typically found in a venture capital transaction includes:

• *Amendment to By-Laws.* Amendments may be required to be sure that the size of the Target's board of directors is sufficient to include representatives of the VC, the indemnification provisions are broad enough, the requisite committees of the Board have been formed, and the VC is able to call a special shareholders and directors meeting;
• *Employment Agreements.* It may be critical to the VC to ensure that key executive employees of the Target are contractually committed and incentivized--revised employment agreements are often delivered at closing of a VC investment;
• *Option Plan and Awards.* The adoption of an option plan for key executive employees or a grant of restricted equity to these employees is frequently a component of a VC transaction;
• *Founder Restricted Stock Agreements*. These agreements between the Target and Founders provide for the vesting and repurchase rights discussed infra;
• *Indemnification Agreements for Directors*. These documents are typically more robust than the provisions in the company's charter. For example, they also deal with the priority of insurance coverage upon a stockholder claim. Often, they will provide that the company's policy pays first and then the director's policy (often a VC fund has policies to protect its agents who serve as directors of portfolio companies);
• *Confidentiality, Non-disclosure, Non-compete and Non-solicitation Agreements.* These agreements are typically required of all, or almost all, employees of the Target on or before closing of a VC investment. The agreements serve to preserve the Target's valuable trade secrets and other intellectual property, protect against the raiding of current employees and customers, and restrain current employees from leaving the Target and competing with it. One critical aspect of this agreement is ensuring that all employees and independent contractors who helped develop intellectual property have freely and fully assigned all of their rights to that intellectual property to the Target. Since most VC investments are in Targets with hopefully valuable intellectual property, this is a key issue. Many early stage companies do not always obtain these assignments, and that is sometimes an issue in a due diligence investigation of the Company. Companies with California employees or domiciled in California need to be cognizant of the unenforceability of non-competition covenants in the state.

VI. Fundamental Structural Issues

15:26. In general

Many issues affecting the Target, founders, and VC arise in structuring a venture capital transaction. While each transaction differs in its own unique respect, based on the nuances, economics, and personalities of each deal, certain themes recur. The following sections deal with issues commonly discussed and resolved in connection with a venture capital transaction.

15:27. Governance

Decision-making, whether on the day-to-day operations of the Target or fundamental issues, presents a frequent source of tension between VCs and founders. Control issues vary dramatically based on the size and stage of each investment.

Transaction documents typically define the size and composition of the Target's board of directors. The governing documents (typically the Voting Rights Agreement in the case of a corporation or an operating agreement in the case of a limited liability company) will prescribe the number of directors and the right of a certain cross-segment of equity holders or management team members to be represented on the board. For example, the board of directors may be comprised of five persons, with one selected by the VC, two by management, and one mutually agreed upon by management and the VC, with the fifth director being an industry expert. The right to appoint a director may be contingent on the VC retaining a certain ownership level or retaining ownership of a meaningful portion of its shares. VCs will often resist losing a board seat just because their ownership has declined as a result of new issuance of shares. As a practical matter, investors in the new round will often want board seats as well, and the earlier round VC typically understands that its service may give way to a seat in favor of those who put in fresh capital, unless the size of the board is perhaps expanded to accommodate both.

While a VC may own a minority of the fully-diluted shares of the Target (i.e., after conversion of all convertible debt and preferred and options), it will nonetheless typically demand a far disproportionate influence in three respects:

- *Voting Power.* The VC's block of stock will usually possess the power to appoint at least one member to the Board. In addition, the VC director usually has the right to wield negative control in many major matters. For example, notwithstanding the fact that the VC may have a minority of the seats on the Board, major company actions such as the issuance of additional securities, sale or merger, or even hiring or firing of key personnel may require the VC director's assent. The scope of these rights is heavily negotiated. The parties will also negotiate the duration of the VC director's right. It may terminate after the next round of significant financing, the passage of time, or the reduction of the VC's ownership below a certain threshold. As discussed earlier, the lack of clarity regarding the efficacy of the ability to waive fiduciary duty at the board level has given way to these veto and blocking rights being focused on more at the stockholder level, not the board level.
- *Board Committees.* The VC may require the Target's board of directors to establish specific subcommittees for particular tasks and thereby enable the VC's director to participate in greater degree in a more focused environment. These committees frequently address audit, compensation, and sometimes technology matters.
- *Information or Observer Rights.* Even if a representative of the VC no longer serves on the board of directors of the Target, the VC will often seek to gain access to information to which other shareholders may not be entitled. The VC may seek to observe or attend board meetings and be furnished the package of information provided to board members. The VC may also obtain the right to receive periodic financial reports and reports of the Target's activities.

15:28. Governance: pension plan investors

Public and private pension plans provide a considerable amount of the capital fueling VC funds. The fact that a VC fund has pension plan investors can influence the fund's desire to participate in the management of Targets in which it invests. If one or more pension plans have investments in a VC fund representing 25% or more of the fund's invested capital, the VC fund will be subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA).[1] If the VC investment is not structured correctly, the cumbersome provisions of ERISA will, for example, impose on the VC fund manager fiduciary duties to consider the impact of the VC fund investments on the beneficiaries and participants in pension plans and may expose the VC fund manager to liability if prudent investment and diversification standards are not met.

The harsh impact of having to comply with ERISA can be avoided if the VC fund is classified as an "operating company" under the plan asset regulations promulgated under ERISA. For these purposes, an operating company is defined as an entity that is primarily engaged, directly or through a majority-owned subsidiary or subsidiaries, in the production or sale of a product or service (other than the investment of capital). A venture capital operating company (VCOC) is treated as an operating company for ERISA purposes if: (a) at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are invested in operating companies in which the VCOC has management rights; and (b) the VCOC actually exercises such management rights with respect to one or more of the operating companies in which it invests.

For this purpose, "management rights" means "contractual rights directly between the VCOC and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company." The Plan Asset Regulations do not provide specific guidance regarding what rights will qualify as management rights, and the United States Department of Labor (DOL) has consistently taken the position that such determination can only be made in light of the surrounding facts and circumstances of each particular case, substantially limiting predictability in this area. The DOL has stated that management rights do not require that a VCOC have the power to direct a portfolio company's management to comply with the VCOC's input, and a VCOC may, for example, have management rights if it has appointed one director to a three (or more) person board. VCs typically receive a "management rights" letter at closing of the investment to document its right to exert such input, and this practice seems to pass DOL muster. Management rights letters are not often heavily negotiated in venture capital investments.

15:29. Additional capital and dilution

Most growth stage companies continually need new capital to grow, and VC-backed companies are no exception. Not until its later stages when its products are "cash cows" will a Target become fortunate enough to internally generate sufficient free cash flow to cover all operating and capital needs. Even at that time, many free cash flow generating companies keep

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29 U.S.C. 18 Employee Retirement Income Security Program.

re-investing in the business by continuing to invest in marketing, sales and product improvement as well as making acquisitions, all of which demand new cash.

An often contentious issue in a VC financing transaction is how to protect the interests of the VC if there are any future “down rounds” and “dilutive” financings. Since any sale of additional ownership interests reduces the existing investors' claims to the Target's assets and income stream, the broadest concept of dilution would render every financing dilutive. A more benign and practical view of dilution is to treat a financing as dilutive only if it negatively impacts on the measure of a business's value. If the value of the business is measured by earnings or book value, then financings reducing those elements are dilutive. For example, assume a business is valued by its owners' equity and that account is $1 million, with A and B owning 50% each. If C buys 25% of the common equity for $250,000, that purchase is dilutive to the existing owners since $250,000 should have purchased only 20% of the business. If C buys 25% of the common equity for $333,333, that purchase is neither dilutive nor accretive to the existing owners. If C buys 25% of the common equity for $500,000, that purchase is accretive to the existing owners.

The following are various structures that can be used to reconcile a VC's desire to avoid dilution with the Target's need for financial flexibility.

1. Preemptive Rights. VCs invariably receive the right to purchase the number of shares or units necessary to maintain their percentage interests in the Target. While preemptive rights are nice to have in theory, in actuality the VC's appetite or capacity for additional investments may very well be satiated by the time additional equity is being raised. On the other hand, many VCs invest initially fully expecting that they will have the opportunity or necessity to participate in follow on rounds and therefore only invest maybe half of their desired stake in the first instance.

Preemptive rights typically terminate upon an IPO and sometimes terminate once the VC's ownership falls below a specified percentage or the VC fails to exercise them in one or more instances. Some of the nuances of pre-emptive rights are discussed above under Investor Rights Agreement.

2. Full-Ratchet Method. The full-ratchet method is the harshest and most punitive VC protection against a “down round,” or a new round of financing for the Target where the price per share sold in that round is less than the price per share purchased by the VC. The full-ratchet method reduces the VC's conversion price of its preferred stock from the purchase price paid by the VC to the purchase price paid by the new purchaser (or, if the VC has already converted its preferred, or has purchased common, the VC will be issued additional shares of common at that lower price).

For example, assume the VC purchased 100,000 shares of preferred stock convertible into common stock at $2 per share and new capital is raised by selling preferred stock convertible into common stock at $0.50 per share. Under the full-ratchet method, the VC's conversion price will be reduced to $0.50, and the VC thus will be entitled to convert its preferred stock into 400,000 shares instead of 100,000. This method has extremely harsh consequences to the founders since their shares are diluted not only by the down round but also by the change in the VC's conversion price. This dilution of the founders' interest is heightened especially if the amount raised in the down round was an insignificant amount of money.

Founders strenuously resist the full-ratchet method. It bears no connection between the amount of new capital raised in the down round and the amount price per share. Let's use an extreme example to illustrate the potential confiscatory nature of the impact; if the last round raised $10 million at $10 per share or 1 million shares and there was a down round raising $1 at $0.01 per share, then the number of shares raised in the previous round would be increased by dividing by that $0.01 for a 100x difference. Obviously, that is an absurd result and is fraught with logistical issues as well as fiduciary ones but illustrates the disproportionality of the concept.

A full ratchet further implies that the founders are guaranteeing that the VC's stock will never go down in price and that the founders are to blame for any such decline. This logic may be appropriate in the rare case where the VC does not participate at all in decision making or on the board of directors of the Target, but in most cases the VC is active and also has the ability to veto the transactions causing significant price declines. Middle ground compromises include: adopting the full-ratchet method for the first 12 months and then using a fairer method thereafter, only employing the full ratchet method if the amount raised exceeds a specified level (to avoid the absurd result conjectured above), or using the full-ratchet method only if new financing is needed resulting from a breach of representations and warranties or covenants of the Target. All this being said, and despite many down funding rounds starting in the second half of 2022 and increased leverage of VCs, the full ratchet method is still rarely used for these reasons. A mitigating offset is that the still active founders are then granted new options at the lower strike price. This may mitigate the impact on the founders, then someone has to bear the brunt of the dilution and then that falls to the founders no longer active in the business or the early investors.

3. Weighted-Average Method. A fairer and much more typical approach to protect the VC against dilution is the weighted-average method. This method also reduces the VC's conversion price to a lower number, but that lower number depends on the number and price of new shares issued in the subsequent offering.

For example, assume that a Target had 200,000 issued and outstanding shares (including the VC's 100,000 shares of convertible preferred and including 20,000 options and warrants to purchase common stock) prior to the new offering, and the VC's initial conversion price was $2 per share. If the Target issued 100,000 additional shares to a new investor at $0.50 per share raising $50,000 in new funds, the VC's conversion price would be reduced from $2 per share to $1.34 per share determined as follows:

New Conversion Price = ((X + Y) / (X + Z)) x Old Conversion Price

In this formula:

X is the number of issued and outstanding shares (including 20,000 options and warrants) before the new financing (i.e., 200,000); Y is the number of shares that the new financing would have purchased using the original higher conversion price (i.e., $50,000 would have purchased 1,000 shares at the original per share price of $2 per share); and Z is the number of shares actually issued as a result of the new financing (i.e., 100,000).

This formula should only apply if subsequent rounds of financing are at lower prices, thus locking in their lower price per share. Complications arise with warrants and options, as well as with subsequent rounds of financing with prices between the original and new price, or with options taken into account in computing X that are very far out of the money so as not likely to ever be exercised. Careful drafting should also exclude shares from X shares for a variety of factors, including the impact of conversion of preferred shares, employee options upon conversion, and shares issued due to a merger or strategic alliance.

If X in the above formula includes all warrants and options (whether in or out of the money), it is known as the "broad-based" weighted-average formula. Since X will by definition be a larger number by virtue of including more shares, this formula will cause less dilution and therefore be favored by the founders and management.

The other weighted average formula is known as the "narrow-based" weighted- average formula. This formula excludes all options and warrants from X, whether or not they are in the money. In the above example, excluding 20,000 options and warrants would result in a new conversion price of $1.28 and thus cause more dilution than the broad-based approach. Due to the resulting lower conversion price than the $1.34 per share resulting from the broad-based weighted average formula, this approach is preferred by the VC although the broad-based approach is more typical.

4. *Play or Pay Method.* Some founders detest the apparent unfairness of the VC receiving the downside adjustment of its conversion price with no risk or obligation to participate in subsequent rounds. The founder with significant bargaining power may require the VC, therefore, to exercise its preemptive rights in order to avail itself of the dilution protection. Some "pay or play" provisions actually require the VC to convert its preferred shares to common at the higher original price if it refuses to participate in a new round of financing or at a minimum lose its preemptive rights or dilution protection in the future. Further, in life science investments where the funding is predicated on the company's attainment of milestones, in the event that the milestones are, in fact, attained and an investor defaults in providing the required additional funding, Stock Purchase Agreements will frequently provide punitive mechanisms for this default. For example, if the price per share of preferred stock was $10 and the VC-1 investor purchased 1 million shares for $10 million and then defaulted on its commitment to fund the next tranche upon successful attainment of a milestone, that VC-1's number of shares may be reduced to $100,000 and implied price per share increased to $1,000. The preferred shares might also be converted to the lower number of common shares.

15:30. Preferred equity

VC investments are virtually always made in the form of preferred equity (stock in a corporation or units in an LLC). Preferred equity comes in one of three basic forms. It may be "straight," where the preferred equity is tantamount to unsecured debt. On a liquidating event (like a control shifting merger, sale, or liquidation), sale proceeds are distributed to pay the preferred and are then distributed to the common holders. The only means for the VC to share in the upside generated from common holdings is to own a warrant to purchase common, which could be exercised at closing.

A second form of preferred stock is convertible preferred. In this case, the VC chooses upon a liquidating event to either receive payment equal to the original price plus dividends or to convert its preferred to common. For example, if the VC purchases preferred equity for $1 million, representing 10% of the Target's equity, the Target is sold for $9 million, and the accrued dividends are $100,000, the VC would elect to receive $1.1 million for its preferred stock instead of taking $900,000 (10% of $9 million) after converting the stock.

Finally, the preferred stock may be structured as "participating." In this case, the VC would receive a return of its investment (sometimes up to eight times!) and then convert to common. For example, assume that the VC's purchases preferred equity for $1 million, representing 10% of the Target's equity, and the Target is sold for $20 million. The VC's participating preferred would entitle it to receive $2.9 million (i.e., the first $1 million as preferred and then 10% of the remaining $19 million representing its ownership of common). In this example, the VC in effect owns 14.5% of the fully-diluted common equity, not 10%.

Participating features frequently rankle. Founders typically argue that a participating preferred in effect treats the VC's investment akin to debt with a penny warrant for the common. This is because the preferred gets paid off first, and then the VC shares in all additional upside. The founders would argue, therefore, that upon a liquidating event, the VC should either be required to convert its stock from preferred to common or simply be paid for its preferred equity investment. Given the assumptions in the example in the prior paragraph, the VC would receive $2 million (i.e., 10% of the $20 million sale price), not $2.9 million.

VCs would respond that, especially in the earliest rounds, little real value or funds have been committed by the founders and treating the VC investment like debt is eminently fair.

After a lot of discussion, the parties sometimes reach a compromise, which allows the VC to participate somewhat and then either be capped (like true preferred) or lose the participating feature.

Adopting participating or straight preferred varies with the economy and parties' negotiating leverage. It remains to be seen whether perceptions of an imminent recession or low growth economy will shift the structures back in favor of the VC and its desire for participating preferred features. Thus far, despite the increased leverage in favor of VC investors since the last quarters of 2022 and into 2023, very few VC investments have been in participating preferred and most are structured as convertible preferred.

As Targets grow, or at least need additional future capital, different layers of capital, typically convertible preferred, will be invested at different times. As noted above, perhaps the early investors will own common stock, then the angel and seed, Seed Stock, the next round Series A and variants, and then Series B, etc. The question becomes how do sale proceeds get distributed upon the sale of the Target? Most commonly, the newer funds (in the above example, Series B Preferred) would get paid, or convert to common, first, followed by the Series A Preferred, followed by the Series Seed Preferred and then the Common stock. As the Target receives more and more layers of financing, however, the complexity of these multiple layers becomes acute. Further, the various governance issues between multiple series of preferred stock becomes even more problematic. Needing to obtain consents from the Class B Preferred, then the Class A Preferred, then the Class Seed, etc., and the amount of time, disclosure and efforts to carryout basic corporate tasks could become unwieldly. Therefore, as the number of rounds increase, many Targets will simply consolidate the different series and classes of preferred stock into one or more. From the company's standpoint, governance is greatly streamlined. From many investors' standpoint, it is also preferable to streamline governance and eliminate the multitude of decision makers, all of whom could delay or extract their price for compliance. Many investors also prefer the collapsing of the layers of preferred for two other subtle reasons. First, many investors feel that their interests should be aligned with the other investors and thereby exert a commonality of perspectives and purpose. Second, if the new money invested continually will have liquidation preference over the older funds, like some archeological dig through sedimentary strands of ancient civilizations, then the next investment round will similarly bury the present round.

15:31. Participating preferred equity: cap approach

A cap on the participating preferred feature is a device to reconcile some of the tensions discussed in the prior section. This compromise permits the preferred to participate until the VC earns a certain multiple of its investment (e.g., three to five times) or a certain internal rate of return (30%-50%).

For example, assume that a VC purchases preferred stock convertible into 10% of the Target's stock for $1 million and has a participation right capped at three times its original investment. If the Target is sold for $21 million and there are no accrued dividends, the VC will receive $3 million (i.e., $1 million as a return on its investment in preferred stock plus 10% of the remaining $20 million). The $3 million cap does not come into play because the VC does not receive more than that amount. If this were a convertible preferred security, the VC's return would have been $2.1 million.

A cap approach reduces the dilutive impact on the founders and other holders of common stock and conversely reduces the return the VC would have had if the cap had not existed. But at some point, it causes the VC to become indifferent about whether the sales price of the Target or the amount received upon some other liquidating event is increased because the amount of the net proceeds received by the VC will not increase.

If the sales price in the preceding example was $25 million, the VC would still receive $3 million. Without the cap, the amount would be $3.4 million ($1 million as a return on its investment in preferred stock plus 10% of the remaining $24 million), but the maximum that can be earned with the cap is three times the VC's initial investment.

The zone of indifference for a particular series of preferred stock subject to a cap is calculated as the difference between X and Y, where X is the value at which the as-converted percentage of the total purchase price equals the cap and Y is the value at which the VC's allocation of the total purchase price calculated on a participating basis equals the cap. Solving for the values of X and Y that satisfy this relationship reduces to the following formulae:

X = Cap / As-Converted Percentage Represented by the Preferred Stock

Y = [(Cap -- Liquidation Preference Amount) + (As-Converted Percentage Represented by the Preferred Stock x Liquidation Preference Amount.)] / As-Converted Percentage Represented by the Preferred Stock

If a VC purchases preferred equity for $1 million representing 10% of the Target's equity and the participating feature is capped at three times that investment, the zone of indifference is $9 million computed as follows:

X = $3 million / 10% = $30 million

Y = [$3 million -- $1 million + (10% x $1,000,000)] / 10% = $21 million

X -- Y = $9 million

This means that the VC receives the same amount on a sale of between $21 million and $30 million. If the price increases to $31, the VC's share of the proceeds increases to $3.1 million, which is the VC's 10% share if all of its preferred stock is converted to common.

15:32. Participating preferred equity: caps and conflicts of interest

As described above, a cap on participating preferred can create a wide range of acquisition prices over which the VC is indifferent. While the purpose of the cap is to minimize the dilutive impact on common stockholders that would otherwise result from uncapped participating preferred, the cap has the unintended consequence of creating this "zone of indifference." It is important for stakeholders--members of the board of directors, founders, common stockholders, and preferred stockholders alike--to understand this zone of indifference and the impact it may have on decision-making dynamics of shareholders when presented with an offer to be acquired. It would be reasonable to assume that a VC investor might be less inclined to push a negotiation with a potential acquirer with the same zeal as founders and other common stockholders in order to extract a value greater than the cap.

The existence of a zone of indifference could potentially lead to a breach of the duty of loyalty of a director of the Target who represents the interests of preferred shareholders. A recent Delaware Chancery Court decision, In re Trados Inc. Shareholder Litigation,[1] alarmingly illustrated this dilemma. In that case, the directors, a majority of whom the preferred stockholders designated, approved a change of control transaction where all of the merger consideration was shared between the preferred stockholders on account of their liquidation preference and the management team under a management compensation program. Given the

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In re Trados Inc. Shareholder Litigation, 73 A.3d 17 (Del. Ch. 2013).

price, the common stockholders received nothing. The common stockholders then sued the board alleging that the directors breached their fiduciary duties since the common stockholders received no merger consideration, alleging that if the board had not approved a sale of the company and it continued to carry out its business plan, the company would have appreciated in value in the future and the common shares would have ultimately become “in the money.” This decision, the plaintiffs contended, resulted from the preferred directors' conflicting loyalties between the preferred and common stockholders. The court denied the preferred director defendants' motion to dismiss the suit and held that the presumption in favor of the business judgment of the preferred directors had been successfully rebutted given this conflict.

A few careful steps could have enabled the preferred directors to avoid this liability. First, the acquisition documents failed to contain any drag-along provisions which would have obviated any board action.[2] Second, the business was a Delaware corporation where the state corporate statute and case law impose various fiduciary duties on directors. If the Target had been a limited liability company, its operating agreement could have disclaimed or limited these types of duties and insulated the directors from this exposure (although this form could have possibly different and inefficient tax results depending on the nature and form of ultimate exit). Third, the directors should have evaluated the breadth and scope of applicable contractual indemnity agreements with the company and corollary charter provisions. Director and officer insurance policies are also an obvious means to reduce, if not eliminate, the economic exposure of liability if not the mere existence of litigation. Fourth, the directors did not develop a careful record of the degree of deliberation and sensitivity which they may have given to the needs of the common stockholders. The court inferred that a better record might have reached the legal conclusion that the directors discharged the appropriate quantum of care. It is possible that the trier of fact will ultimately reach this conclusion, many years and countless dollars later.

§ 15:33. [RESERVED]

15:34. Exit strategies

The VC's attitude regarding the ultimate disposition of its investment varies based on the nature and risk tolerance of the VC. Most VCs are venture capital funds whose fund documents impose a finite life of the fund, typically seven to 10 years, with certain limited rights to extend, in which they expect their investment to remain outstanding before it is monetized.[1] This relatively short time horizon is dictated by several factors. One of the primary factors is that investors in VC funds demand a payback in a relatively short period of time, and therefore the VC is merely expressing the needs and demands of its clientele.

Many institutional investors may tolerate a longer holding period based on the nature and

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For a discussion of drag-along rights, see §15:36.

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National Venture Capital Association, Frequently Asked Questions, http://www.nvca.org/faqs.html.

quality of the investment. Pension funds and insurance companies, whose obligations to beneficiaries extend for decades in the future justify holding an asset like a stock that far in the future. But insurance companies, as taxpaying entities unlike pension funds, have to be concerned with paying significant capital gains taxes on long-term holdings. The implied tax liability to Berkshire Hathaway, for example, based on its current gains in Coca-Cola, Apple, Bank of America, American Express and many others (obviously not venture investments although Apple had been long before Berkshire began purchasing shares) is in the billions of dollars.

A blueprint to ultimately dispose of the investment, therefore, is a major priority of a VC and is a prominent topic during the negotiations. In other words, savvy VCs will always start with the end in mind--how are we likely to exit this investment and when? The blueprint for the VC's ultimate exit may take several forms, as is discussed in the following sections.

15:35. Exit strategies: general transfer restrictions

VCs want to ensure that the founders will not be able to freely sell their shares in the Target. If the founders are financially "joined at the hip" with the VC that has invested in the Target, they will stay focused and motivated. The founders may agree to these restrictions for a certain period of time (three to five years), but after that time elapses will want to be permitted to sell to any third party, subject to the rights of first refusal and co-sale provisions in the Co-Sale and Right of First Refusal Agreement discussed above. Founders may also be permitted to sell a de minimis amount of stock for liquidity and estate planning purposes.

VCs may not want any restrictions on their own ability to sell any shares at any time but may have to agree not to sell their shares for some period of time for the same reasons they wish to prevent the founders from selling the founders' shares. Given the needs of VC funds to monetize their investments as their business is return driven, most resist any such impositions.

Transfer restrictions ordinarily provide that any sale may be subject to the applicability of the securities laws restrictions on the sale of unregistered securities. Sales may also be subject to drag-along or tag-along rights or rights of first refusal, offer, or negotiation. These restrictions and provisions (except for drag-along provisions which are usually found in the Voting Agreement) are typically set forth in the NVCA model form of Co-Sale and Right of First Refusal Agreement as discussed above.

15:36. Exit strategies: drag-along and tag-along rights

VCs typically are not subject to right of first refusal provisions and are legally just constrained from selling their shares by securities law restrictions and the practicality of selling a minority interest. Of course, as the value of the VC's stake grows, a more fulsome secondary market in minority shares can develop and provide some measure of liquidity and price transparency. This tends to be the exception, not the rule, however.

After the expiration of any holding period that prohibits any or all owners from transferring their shares for a period of time, the VC may desire to sell its shares to third parties. Since the VC does not own all of the Target's shares, the VC's efforts to sell the Target may be thwarted if the third-party buyer desires to purchase all of the Target stock. Therefore, VCs who own a majority or a large minority percentage of the shares of the Target typically require the right to cause the founders' and others' shares to be dragged along and sold to the buyer at the same price and terms (subject to the liquidation preferences for capital) if either the buyer requests or the VC believes that the sale of all of the stock will enhance the prospects for sale of the Target. Founders may oppose the VC's right to sell their shares at any time and attempt to place sometime, and perhaps performance, limitations. Otherwise, a VC may choose to sell its shares simply as an escape mechanism, oblivious to the founders' years of effort and belief in the viability of the Target. Drag-along rights are rarely, if ever, granted to founders acting alone.

The founders may also have concerns about the VC's sale of its shares of the Target. While the founders or the Target may extract a right to first refusal, offer, or negotiation relating to such a sale, the founders may feel that their ability to purchase a VC's shares is illusory since the founders do not have a realistic access to capital to acquire the shares. The VC's reply is that this inability should not preclude its opportunity to sell and should not harm the founders, since in substance one investor is merely being replaced by another. VCs will therefore strenuously resist their ability to sell their shares. In reality, the ability to sell illiquid shares in a private company owning a minority interest should not be considered very easy (unless there is a secondary market for unicorn stocks) and is often made at a significant discount. Whether this view is true depends in part on the degree the selling VC participates in or actually controls the Target.

To resolve the founders' concerns, the founders may be given tag-along or piggyback rights enabling them to sell their shares at the same time and price as the VC's shares (subject to liquidation preferences). Giving the founders tag-along rights may be acceptable to the VC if the rights are ineffective if the buyer genuinely would not buy the Target unless the founders maintain their same ownership interest and therefore have the same motivation inherent in ownership of a business. This concern is only rarely voiced by buyers, and many avenues pave the way to address this concern, including selling some of the founders' stock and rolling the balance over on a tax deferred basis into the buyer's entity, giving options to founders to buy stock in the buyer company, or selling the founders some stock in the buyer company.

Practice Tips:

In drafting tag-along clauses, consideration needs to be given to how they will operate if less than all of the stock of the Target is to be sold. If a tag-along clause simply allows the founders to sell their stock on the same basis as the VC, the clause leaves unanswered the question of what happens if the buyer wants to purchase 30% of the stock of the Target and the VC owns 30% and the Founders own 70%. If the buyer is unwilling to purchase more than 30% of the stock, the tag along may mean that the VC may now only sell 9% of its shares (30% of the 30%) and the founders may also sell 21% of their shares (70% of the 30%) to give the buyer the desired 30% of the total stock in the Target. This obviously is a completely unacceptable result for the VC and also detracts from the prohibition on Founders being able to exit early.

In drafting tag-along and drag-along clauses, the impact of participation rights is also critical. If the selling price is $100X and the VC's preferred is valued at $100X, then it is inaccurate to say that all holders will receive the same price, terms, and conditions. The documents will need to specify that the holder's entitlement to these items is subject to liquidation and similar preferences.

15:37. Exit strategies: right to cause a sale

A rare, but hotly contested, exit strategy affords the VC, upon the occurrence of certain triggering events, the right to cause the business to be sold or merged. VCs that own a majority or close to a majority of the shares of the Target typically demand this right, which they can exercise at various times. The parties may agree that some time should elapse before this right could be triggered in order to give the founders a chance to implement the business plan. In lieu of tying the right to cause a sale to a specific time period, some arrangements require the occurrence of some event such as a deadlock on major issues, failure to achieve targeted milestones or other financial goals, the failure to honor a redemption provision, the departure of a key founder or significant misrepresentations and warranties in the financing documents. Unlike private equity transactions where the parties often agree to give either party the right to sell the business at any time, or after a certain time, for a price not less than an appraised or agreed to minimum value, you rarely see this approach in venture capital. The other party would then have the right to match that price prior to the time the business is marketed for sale. VCs that own a small to modest minority position rarely if ever have the right to cause the company to be sold. VCs desiring an exit have to rely on many of the means described herein, such as secondary transactions, a tag-along when a larger owner sells, a required redemption or the Target's sale or IPO.

15:38. Exit strategies: rights of first refusal, offer and negotiation

To achieve the goal of maintaining continuity of ownership, each non-VC shareholder frequently gives the right of first refusal to the other shareholders prior to the sale of the shareholder's stock. This right allows the non-selling shareholders to match a bona fide arm's length offer made by a third party. Since the offer which is desired to be accepted is from an unrelated third party, it is thought to be for a fair price. If the selling shareholder is offering an unreasonably low price to the third party due to the seller's personal circumstances necessitating the sale, the other shareholders can reap this benefit by exercising the right of first refusal. Sometimes of course that right could be illusory if the other shareholders do not have the funds to purchase the seller's share or the would-be buyer is offering some form of consideration that is difficult to match, like equity interests. If the price the third party is willing to pay is very high, the non-selling shareholders are not required to exercise their first refusal right. Indeed, the other shareholders may be able to avail themselves of a tag-along right, or, in some circumstances, cause the conversion of the selling shareholder's interest to nonvoting stock. Some clauses restrict transfers to competitors, as such term is determined by the disinterested board. Ironically, while transfers to competitors may be prohibited, rarely do such clauses restrict transfers to others in the Target's supply chain, like vendors or customers.

Many, particularly VC funds, object to the concept of a right of first refusal encumbering their shares, whether to other VCs or to Founders, on the grounds that this right may have a chilling effect on would-be purchasers of their shares. In turn, the third-party purchaser's enthusiasm is repressed by in effect not knowing whether its deal will be consummated or will be dragged out. Third-party purchasers also resist acting as the stalking horse to set the price that someone else can match.

Whether the right of first refusal triggered by a Founder or other common stockholder's sale of shares should also be conferred to another Founder is sometimes an issue. Once the Target declines to exercise the right, the VCs aver that they may desire to keep the Founder shares in friendly hands or simply desire to add more company shares to its portfolio. Further, Founders often lack the requisite access to the level of capital that would be required in the purchase of other common stockholders' sale.

Founders will counter that they would like a right of first refusal on the sale of a VC's shares, to keep the preferred owners in known hands. Further, they may feel that each VC fund is unique, was selected based on the chemistry or kindred philosophies, and the founders should therefore have the right to decide with whom to do business. VCs are rarely sympathetic to these contractual wishes as VCs prefer optionality on the disposition of their shares. As a practical matter, VCs may provide an informal right of first offer to one or more groups of stockholders (see below) but only informally and not contractually. Founders also typically receive the right to sell or transfer their shares to family members, trust etc. who become party to the restrictions or sell a de minimis amount of shares without restriction. 3 to 5% is the typical range of de minimis sales to third parties which would not trigger a right of first refusal.

To address the concern that rights of first refusal may have the practical impact of reducing the universe and attractiveness of potential purchasers of privately held stock, some co-sale and right of first refusal and other types of stockholder agreements provide for rights of first offer and first negotiation, although this concept is not present in the model NVCA Co-Sale and Right of First Refusal Agreement. A right of first offer essentially requires the selling shareholder to first make an offer to the non-selling shareholders at a price the selling shareholder would be willing to sell its shares. If the non-selling shareholders do not wish to purchase the shares at this price, then the selling shareholder has a finite period of time to market the shares for a price equal to or above the offered price. This approach enables the non-selling shareholders to assure that the price is fair by giving them an opportunity to participate in the purchase. It also allows the selling shareholder to pursue the sale without the specter that a would-be purchaser will be discouraged by the existence of the right of first refusal.

The time period during which the shares must be sold at or above the offered price should be kept relatively short (e.g., not more than six months). This minimizes the psychological and logistical impact of having the business or large block of stock being perpetually up for sale.

The right of first offer should also adjust for the circumstance where the price is ultimately reduced below the offer price (e.g., due to a purchase price adjustment between signing and closing caused by losses or declining levels of working capital). A modest, let's say 5%, reduction below the offer price is generally accepted as reflecting the realities that the business can deteriorate by some amount without starting the entire right of first offer process over again from scratch.

Some VCs and other sellers believe that a right of first offer also has a chilling effect on would-be purchasers due to the many timing and price caveats contained in first offer provisions. For example, the possibility that the value of the business may decline and thus reduce the sale price below the offer price, or the closing may be delayed due to financing or regulatory reasons and, therefore, the process must be recommenced, may serve to dissuade many possible purchasers from trying to buy the shares. Therefore, some agreements only require the parties to negotiate in good faith for a finite period. If this right of first negotiation does not result in a binding agreement within a finite period, then the selling shareholder is free to sell for any price, even a price below the previous negotiated price. This approach provides the selling shareholder with the most certainty that its sales efforts will not be impeded by the other shareholders' rights. Considerable subjectivity, however, regarding the standards of good faith negotiation abounds, and the threat of litigation over this issue could loom large. The ability to negotiate in good faith with parties with whom distrust or antagonism may be present is also difficult.

15:39. Exit strategies: redemption rights

A VC may seek rights to require the Target to purchase its shares, or a put, as the VC's exit strategy. The put may be triggered by the lapse of time, the occurrence of deadlock, a material breach of the representations and warranties in the stock purchase agreement, the departure of key founders, or a failure to meet specified milestones such as financial targets or obtaining a patent or getting a product commercialized. The put price might be either the liquidation value of the VC's preferred equity (i.e., the net book value of the preferred less any returns of capital plus all accrued dividends) or some formula or appraised value for the common equity. While a formula value is sometimes used (e.g., depending on a multitude of factors including the company's stage of development, growth trajectory and industry dynamics, a multiple of annualized recurring revenues, EBITDA, revenues, or net earnings), this method can be dangerous since fair and appropriate formulas vary over time and the current risk profile and stage of the business.

A put right is also of questionable value in a real practical sense. If the Target is doing well, the VC has other means available to it to liquefy its position. If the business is doing poorly, the Target may not have a means of financing the put, and therefore, the impact of the put is to convert the VC's equity to the right of an unsecured creditor.

Some Targets might try to extract a right to purchase, or a call, from the VC as the logical mirror of a put. The pricing and terms of the call may be the same as the put, except the call right is usually delayed for a year or two after the time that the VC is first able to exercise the put.

The value of a put right may be discounted by a small percentage, say 5% to 15%, as the price the VC is willing to accept to convert its investment to cash. Conversely, a call right may carry a 5% to 15% premium (or perhaps a premium which declines over time) to compensate the VC for having its interest redeemed involuntarily.

VCs resist call rights since they cap price appreciation and may be exercised prior to a significant monetizing event such as a sale or IPO. The Target may retort that the call is a last resort and may only be exercised after the VC has had the right to put the stock. Further, the VC can in effect negate or soften the impact of the call by converting its preferred stock to common.

The call treats the VC fairly, moreover, since the price of the preferred stock is fixed and the value of the common stock will be fair market value.

Founders may also ask for puts (and expect calls) in some circumstances. Death, disability, and termination of a founder's employment with the Target without cause are frequent triggering events. In the event that a founder is terminated without cause, the founder may also seek a right to revalue the put or call price if the Target is sold for a higher price within a six month to one year period. This revaluation right keeps the Target honest and prevents it from terminating the founder prior to a contemplated sale. Many agreements, however, do not provide for any such put or call upon the founders' departure. Instead, the founder will simply retain the vested portion of his or her equity and go along for the proverbial ride.

Finally, payment terms for the puts and calls need to be set by advance agreement. If the Target cannot afford, or does not desire, to use cash, it frequently has the alternative to defer payment. The payment period for repayment is usually two to three years shorter with a call (since the company initiated the call) than with a put. The interest rate may also be higher with a call than a put. Granting security to the redeemed shareholder, except for a security interest in the shares being repurchased, is rare. Limiting payments under a put to some percentage of the company's net cash flow should also be considered to assure that the business can still operate and will not be unnecessarily burdened by the put or call. Finally, acceleration in a sale or change of control should be expected.

Most state laws prohibit distributions and their payments like redemption payments if the company is or would become insolvent. Certainly, most companies with bank loans would restrict those payments as well. Therefore, the deal documents should carefully spell out the consequences of the company's inability to honor its redemption obligations. Interest rates can frequently keep ratcheting up to incentivize payment or at least compensate for the longer wait. Recent changes to NVCA model form of Certificate of Incorporation solidifies this concept. At some point, the VC should have the right to cause the sale of the company to consummate its redemption. Presumably a creditor would have nowhere near the fiduciary duties as a preferred stockholder in carrying out that sale.

While some VCs may desire the flexibility to be able to cause a sale of the stock or assets of the business at any time, the founders will want to limit the periods during which the business is being shopped. This reduces the negative impact on employee morale and customer confidence that naturally occurs during the sale period. Whether this type of right will be conferred on VCs will also vary with the ownership level and whether certain performance milestones were required to be met.

15:40. Exit strategies: registration rights

A VC's final, and often ultimate, exit strategy is the right to demand that the Target register the VC's shares on the public market in an IPO or subsequent registration. These registration rights will be documented in a registration rights agreement. The NVCA model documents set forth these terms in an Investor Rights Agreement. Seed Round documents do not introduce this concept, presumably due to the very early stage of the company. Seed round investors therefore need to be aware of this gap and protect themselves to avoid not being conferred these rights when other preferred holders may obtain them. At a minimum, the Seed stockholders should seek piggyback registration rights to sell alongside the Series A preferred. Ironically, these registration rights agreements are usually either negotiated with the fictional and absent future underwriter in mind or subsequently changed by the underwriter who has a substantial role in determining the marketability of the shares.

VCs desire the right to demand registration of their shares at any time, regardless of whether the business is then public or is planning an IPO. Like the right to sell the business at any time, VCs feel they need this flexibility to ultimately monetize their investment independent of the Target's perhaps countervailing wishes. The founders typically respond that the ability to demand registration at any time under any conditions gives too much power to the VC and evinces little support and conviction in the investment. At the first sign that the business is doing well, the VC could exit, even though the cost, disruption, competitive disclosures, price fluctuations and other scrutiny placed on a public company is often felt unwarranted or at least premature. Further, the right to demand registration prior to the Target's IPO sends a message to the marketplace that the sophisticated investor group smells trouble and wants out, thus imperiling the ultimate IPO. Of course, the selling VC may just feel that the timing is propitious for an exit, its fund life may be nearing an end, or the VC feels it can add more value giving advice at an early not late stage. Finally, being a public company fundamentally changes the Target, in terms of its operations, compliance cost, potential liability, potential vulnerability to unwanted takeover in the event the share price plummets, disclosure of sensitive information which could result in competitive harm and reporting relationships. Some founders weigh these many inconveniences more strongly than some of the positive aspects of going public and want to participate in such a dramatic decision. The reality is more muted. A VC can hardly snap its fingers and expect that the markets will be ready for an IPO of the target company. Most VCs are far more sophisticated to place a lot of solace in these rights. The most likely circumstance where the demand rights come into being are in the case of a proverbial unicorn, a company with a reasonable expectation of an equity valuation of a billion dollars or more. In that circumstance, assuming geed does not take over, the Founders and VCs might be legitimately at odds over the appropriate course of action. Going public now brings in fresh capital to grow and, at some point, take money off the table. Conversely, selling too soon as well as subjecting the company to the market fluctuations, cost and short-term market scrutiny of disclosures as well as quarterly performance suggest prudence and delays in filing. Of course, with a true unicorn, a VC could possibly avail itself of other exit mechanisms including secondary sales.

15:41. Exit strategies: registration rights pre-IPO

Many compromise positions reconcile the parties' conflicting goals. A common approach affords a VC or group of VCs the right to demand public registration of the Target's shares, even before an IPO, after a certain period of time, typically three to five years from the investment, if certain conditions are met. A certain high percentage, usually 40% to 75%, of the preferred shares must join in the demand. This assures solidarity of the VC group for this major event. The amount that the underwriters believe will likely be raised must exceed a threshold, typically gross proceeds of between $20 million to $50 million.

As a trade-off for the right to require the Target to register its shares under an IPO, the VCs are required to accept underwriter marketing restrictions on the time and manner of sale of the shares. These underwriter cutbacks and lockups defer to the underwriter's purported superior knowledge of the marketplace and its view regarding the best way to price and market the shares. Underwriters frequently restrict, if not eliminate, the right of the VCs and founders to sell on the IPO and for a finite period, typically 180 days, after the IPO. Underwriters believe these restrictions show confidence in the company to the marketplace. The restrictions further prevent an overhang of supply of shares desired to be sold, which supply will depress the share price. Many would-be buyers, moreover, are not interested in buying into a company when the insiders who know most about the company are bailing. Further, if the underwriter does permit VCs and founders to sell some of their stock on the IPO (which rarely occurs), the underwriter may reduce or cut back the number of shares permitted to be sold if market conditions so dictate.

If VCs are not given the right to require an IPO upon meeting certain market conditions, then they will attempt to receive a right to demand an IPO after the passage of a certain amount of time. If the Target has not registered for an IPO within three to five years, then a VC will sometimes want the right, notwithstanding any dollar or size restrictions, to market the Target or its shares by way of an IPO. While this right sounds helpful, it too may be hollow. If the Target is doing well, it may have already gone public or be generating sufficient cash flow to buy back the VC's shares. If the Target is not doing well, the ability to dump its shares on an unwitting public is doubtful. Granting such a right, furthermore, allows one shareholder or group of shareholders to cause the Target to fundamentally change its nature and character from a private to a public company.

Many nuances abound in registration rights agreements which could impede the efficacy of the registration process as a liquidity tool. For example, the VC may not be able to demand registration if the company is about to deliver a material piece of news (bad earnings, an acquisition etc.). The underwriter will also have the right to cut back the shares desired to be sold or proportion them with other blocks of shares.

15:42. Exit strategies: registration rights post-IPO

If the Target's shares are already public, the VC may have anywhere from one to an unlimited number of demand registration rights, subject to a multitude of restrictions. The VC and founders will, absent an agreement to the contrary, be able to sell their shares, even if they are not registered, under SEC Rule 144.[1] They may also be able to sell the shares through a private offering under an exemption from registration under Regulation D.[2]

The Rule 144 safe harbor specifies the manner in which unregistered (“restricted”) shares held by VCs and founders may be sold in the open market after the Target makes a public offering. Differing rules apply depending on whether the holder is an “affiliate” of the Target. If a VC or founder is not an affiliate of the Target (i.e., if the VC or founder is no longer directly or

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17 C.F.R. §230.144.

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17 C.F.R. §§230.501 to 230.508. For a discussion of Regulation D, see §§17:10 to 17:21.

indirectly a director, key employee, or owner of in excess of 10% of the voting stock of the Target) and has not been an affiliate for a period of three months, the VC or founder's shares may be sold to the public without any restriction after six months if the Target is subject to the reporting requirements of the Securities Exchange Act of 1934, or after one year if the Target is not subject to the reporting requirements. If the VC or founder is an affiliate, it may sell shares after the time periods described in the preceding provisions in “dribble out” amounts in broker transactions. These dribble out rules limit the number of shares that can be sold, in any three-month period, to the greater of 1% of the Target's outstanding shares or the average weekly reported trading volume for the four calendar weeks preceding the filing of the required notice of sale. The dribble-out restrictions are removed after a shareholder ceases to be an affiliate for a three-month period and the shareholder has held the shares for a six-month or one-year period, depending on whether the Target is subject to the reporting requirements of the Securities Exchange Act of 1934.

If the VC or founder is an affiliate and desires to sell shares in a public target, it must file a notice with the SEC on Form 144 if the sale involves more than 5,000 shares or the aggregate dollar amount is greater than $50,000 in any three-month period. The sale must take place within three months of filing the form, and if the securities have not been sold, an amended notice must be filed.

Some registration rights agreements also require Target to file a “shelf registration” at its expense and to keep the registration statement effective for nine or more months. This S-3 shelf registration process is not expensive and provides owners of restricted unregistered shares the right to sell the rest of their shares in a straightforward manner, without the Rule 144 restrictions. Most agreements provide for an unlimited number of such S-3 registrations provided a minimum dollar volume is sold in each tranche of shares so registered.

15:43. Exit strategies: registration rights-- Delay of registration

Demand registration rights may be restricted further by the Target in certain circumstances. To comply with securities law requirements regarding full disclosure of material events, the board of directors of the Target may have the right, if not the obligation, to delay the exercise of any demand right if the Target is undergoing material events. For example, if the Target is in the middle of a significant acquisition negotiation, or is suffering a financially troubling quarter, the board may believe that the disclosure required by a public offering or a subsequent public offering (a “secondary offering”) may hurt the Target's business and stock price. The board's ability to delay exercise of these rights is typically limited to a 90 to 120 day period and no more than one or two such periods during any one year.

15:44. Exit strategies: registration rights and piggyback rights

Once the Target is public, the VC and founders are typically afforded an unlimited number of rights to sell shares at a time when the Target is engaging in an additional sale of its shares. These “piggyback” registration rights are also subject to underwriter cutbacks and lockups. They also typically prioritize the relative rights of the shareholders who are availing themselves of the piggyback right. For example, if the Target desires to sell one million shares, the VCs desire to sell 500,000 shares, the founders desire to sell one million shares, and the underwriter determines that market conditions will only permit the sale of 1.5 million shares, the piggyback provisions will usually allow the Target to sell all one million of its desired shares and then the remaining 500,000 may be allocated two-thirds to the VC and one-third to the founders. Some piggyback clauses provide that the party whose desired sale of shares is being reduced cannot be cut back any more than 70% of its desired number, so at least they are assured that some of their shares could be sold.

15:45. Exit Strategies: registration rights and expenses

Although the Target may require the requesting party to pay for registration expenses, the Target usually bears most of the costs of registration rights. The legal, accounting, brokers, underwriting discounts, blue sky registration, printing, and other related costs is therefore absorbed by the Target notwithstanding its mere acquiescence with the IPO or secondary offering. The cost of counsel for the selling shareholders is typically limited to the cost of one counsel selected for the entire group. The cost of any disclosure relating to a particular selling shareholder is usually borne by that shareholder. If the Target needs to do a completely new audit since its last audit is not sufficiently current (i.e., it should not exceed more than 134 days old), that cost may be borne by the requesting shareholders. Sales commissions and other expenses unique to a selling shareholder are paid by that shareholder. The selling shareholder will also pay for, and indemnify the Target for, any misrepresentations made by that shareholder regarding the shares or the Target.

15:46. Compensation of VC fund managers

VC funds are typically managed by professional VCs (“GPs”). GPs are typically compensated in two ways. First, they receive a management fee of between 1 and 2% of the committed capital of the fund during the first four to five years of the fund life during which time the initial and follow on investments are made. Thereafter, the fee is typically computed based on the actual unreturned and unwritten off capital contributions of fund investors still remaining under management. Second, the GP receives a portion of the profits made by the VC fund--commonly called a “carried interest.” The value of a carried interest is unknown at the time it is created because it depends on future profits, so the tax on the carried interest is postponed until the fund realizes profits by selling or otherwise monetizing its investments. The profits are taxed as long-term capital gains if they are realized on investments held for more than one year.

Over the past few years, there has been heated discussion of a change in the taxation of carried interests to treat them as ordinary income and not as long-term capital gains. The 2017 federal income tax law retained treatment of carried interests at long term capital rates provided the sold asset triggering the gain was held at least three years, instead of the previous one year. Limited partner investors still retain the one year holding period to receive long term capital gain treatment.

The policy underpinning of the debate goes to the core of our society. Venture capitalists argue that treating a carried interest as long term capital gains (even with the elongated three-year holding period) represents an incentive for them to invest in America's most promising companies and continue to fuel the U.S. economy. VCs only realize a return on their investment if the company goes public or is merged or purchased by another company. This type of investing is high-risk and it is estimated that about 40% of venture-backed companies fail, 40% return moderate amounts of capital, and only 20% produce high returns. Others argue that this form of compensation is tantamount to a bonus or unexercised stock options which should be taxed at ordinary income rates.

VII. Choice of Entity and Federal Tax Considerations

15:47. In general

The Target will typically be organized as a corporation (typically under the tax regime of Subchapter C of the Internal Revenue Code) or a limited liability company. In the early stage, Target may be organized as an LLC to achieve pass-through of losses to its owners and tax any distributions only once and not twice as they would be in a C corporation. However, countervailing considerations often favor the Target to take C corporation, rather than LLC, form as discussed below or convert from an LLC to a corporation contemporaneous with the initial closing of VC funding.

15:48. Limitations of S corporations

Although the S corporation form will also permit losses and deductions to pass through to the Target's owners and there is only one layer of taxation on most distributions, such pass-through treatment is achieved with limitations as to the number and types of owners of the Target. More importantly however, the S corporation form permits only one class of equity. This limitation is critical since, as discussed above, most VC transactions involve one or more classes of preferred stock. Therefore, an S corporation is never used in VC transactions since VC funds are not qualified S corporation stockholders and the type of issued preferred security to most VCs is incompatible with classification as an S corporation.

15:49. Unrelated business taxable income

A difficulty in attracting VC capital investment to a Target organized as an LLC is created where investors in the VC fund include qualified benefit plans and other tax-exempt investors. The distributive share items flowing from an LLC to retirement plan investors will likely give rise to unrelated business taxable income thereby subjecting the otherwise tax-exempt investor to current taxation on such earnings. While the VC fund can set up a “blocker” C corporation to trap this unrelated business taxable income, many funds prefer not to undertake this expense and administrative inconvenience, as well as risk a double tax with distributions trapped in the C corporation. Many VCs also do not like waiting for often last minute or late K-1s from the target LLCs as this also causes embarrassment or anger from the investors in the VC funds who, in turn, have to wait for the VCs to issue their K-1s which are delayed due to waiting for the LLC investments' reporting.

15:50. Exit strategy and acquisitive reorganization transactions

While the pass through of early stage losses is important to some classes of investors, a well-counseled Target will choose its form in part on its likely exit strategy. While no one has a crystal ball regarding the type of ultimate disposition, if there is a high probability that the Target's exit will be a sale to a public company for a purchase price which includes a large portion of equity in the buyer, or the exit is likely to be more than five years in the future to avail itself of QSBS treatment (see below), the Target should move to be in corporate form well in advance of such acquisition transaction. The tax-free reorganization provisions of I.R.C. §368 provide rules for the nontaxable receipt of acquirer stock when the Target is in corporate form. The favorable provisions of that Code section do not apply to LLCs, as they are typically treated as partnerships for tax purposes.[1] If the Target is an LLC, it may not be able to time its conversion to corporate form in a way to be sure that the conversion will not be considered a subterfuge by the IRS or the conversion will not trigger an income tax on the appreciation of the Target's assets.

15:51. Qualified small business stock

Other benefits of choosing a C corporation form for a Target are found in I.R.C. §§1202 and 1045, which are designed to encourage investments in start-up companies. Section 1202 excludes gain realized on the disposition of qualified small business stock by non-corporate taxpayers if the stock has been held for more than five years. Qualified small business stock ("QSBS") is stock in a C corporation that is originally issued after August 10, 1993 and is acquired by the taxpayer in exchange for money, property, or as compensation for services. This does not include stock that was issued to one stockholder and purchased by another stockholder; that secondary transfer breaks the 1202 stock chain. The corporation may not have aggregate gross assets (i.e., the amount of cash and aggregate adjusted bases of the property) in excess of $50 million before and immediately after the time the stock is issued. An option to acquire stock cannot be qualified small business stock under I.R.C. §1202.[1]

At one time, only part of the gain on qualified small business stock was excluded from taxable gain under §1202 and the excluded portion was an item of tax preference subject to alternative minimum tax. This rule was initially changed for stock acquired after September 27, 2010 and before January 1, 2015 and the gain on such stock was fully excluded and no portion of the gain was an item of tax preference.

The stock must also be an original issuance by the corporation. Resold stock will not qualify. Nor will stock in an entity which has converted from an LLC, although there are cumbersome ways to try to shoehorn in 1202 tax treatment in that case.

All good things come to an end. The amount of exclusion is limited to the greater of ten times the stockholder's cost basis or $10 million.

Under I.R.C. §1045, if a non-corporate taxpayer holds qualified small business stock for more than six months before its sale and uses the sale proceeds to purchase other qualified small

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For a discussion of the tax-free reorganization provisions of the Code, see §§26:1 et seq.

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Natkunanathan v. C.I.R., 479 Fed. Appx. 775, 2012-2 U.S. Tax Cas. (CCH) &p;50456, 110 A.F.T.R.2d 2012-5193 (9th Cir. 2012).

business stock within 60 days after the sale, the entire gain can be rolled over tax free into the replacement stock. There is no gain recognized on the sale of the original qualified small business stock. The basis in the stock given up in the exchange becomes the taxpayer's basis in the stock received in the exchange, so any gain is deferred. But if the qualified small business stock received in the exchange is held for more than five years, the holder can avoid the recognition of gain on a sale or taxable exchange under I.R.C. §1202.

Given less than robust exit valuations and some funds feeling trapped inside a losing investment, you are seeing more and more provisions permitting VC funds or other investors to sell their equity back to the Target for a nominal amount. This gets the investment off the balance sheet of the investor and triggers a capital loss. Both the Target and investor need to be sure, however, that that too great a percentage of redemptions will disqualify all stockholders from 1202 treatment.

A new income tax provision created close to 9000 “opportunity zones” throughout the United States and its possession. These are blighted areas where redevelopment is desired. If gain from the sale of appreciated stock (presumably not 1202 or 1045 stock since there are exclusions for these securities discussed above) is contributed to a qualified opportunity fund within 180 days of the sale, then 10% of the gain will be excluded if the assets held by the fund in that qualified opportunity zone (which need to be purchased with the proceeds within 30 months) is held more than five years and 15% is excluded if held for more than seven years and 100% of the gain from the investment of the fund's assets is excluded if the fund held those assets for over 10 years.

VIII. Federal Income Taxation of Equity-Based Compensation Arrangements

15:52. In general

Attracting, motivating and retaining key executive talent is a major goal of any Target, no matter how well established or nascent. While this chapter is not focused on tax issues, the following sections set forth basic equity based compensation principles. In many VC-backed companies, employees receive less base compensation in exchange for the promise of a big payday in the future, represented by appreciation in the value of the company. The challenge described in this and the remaining sections of this chapter are to do so in a tax efficient manner aligning the goals of cash investors and those providing sweat equity.

15:53. Restricted stock

Founders with the founder shares and key management personnel are often granted stock, typically common stock, in exchange for their management services. Granting of stock is far more tax efficient to the owner since it will be taxed at the much lower capital gains rate if held for the requisite one year holding period. As mentioned above, the stock could have vesting provisions so that if there is a departure, the unvested shares will be forfeited. Granting stock to a founder is often tax efficient since the company's value is nominal at the time.

If the ownership of the stock is subject to a substantial risk of forfeiture or other restrictions, then the founder/executive will owe no income tax until such restrictions substantially lapse. Upon the lapsing of the restrictions, however, the founder and executive will owe income tax, at ordinary income tax rates, on the then fair market value of the stock in excess of its basis. While appropriate discounting (for minority interests, illiquidity, and perhaps subordination of common stock to other layers of preferred stock) may reduce the value of the stock and therefore reduce the income recognizable by the executive, nonetheless substantial appreciation may have occurred from the date of original grant. Once the executive pays the income tax on the receipt of the stock, any future appreciation would be taxed at long term capital gains rates, assuming the requisite one-year holding period is met.[1] It is also possible that the gain will be subject to the favorable tax treatment accorded qualified small business stock.[2]

To avoid a potentially large income tax obligation at ordinary income tax rates, and to convert future appreciation from ordinary to capital gains rates, executives are often encouraged to make an election under I.R.C. §83(b) at the time of receipt of the stock. This election, which must be made and filed with the I.R.S. within 30 days of receipt of the stock, allows the executive to pay income tax at ordinary income tax rates on the fair market value of the stock (again, with appropriate discounts) upon receipt. Any future appreciation is therefore taxed at long term capital gain rates (assuming the one-year holding period is met). For example, 1000 common shares are granted at $10 a share, with vesting in four equal annual 25% tranches. The executive could either make an 83(b) election and pay income tax on the entire $10,000 at once (see next paragraph). The tax could be a disincentive to the executive, however. This is particularly true if the stock is subject to vesting and the executive pays the tax, then soon leaves the company, the company repurchases the unvested stock and the executive has paid income tax on stock she no longer owns! Instead, the executive might want to make an 83(b) election each time the substantial risk of forfeiture lapses. The risk here is that if the stock appreciates before the risk of forfeiture lapses, the executive's tax is higher. For example, if at the end of year one, the stock price has increased to $15 per share, then the executive would pay tax not on 25% of $10,000 but on 25% of $15,000. Note that since the granting of stock in exchange for services is considered income, the corollary is that the company recognizes a compensation expense for this item. If the election is not timely made, therefore, and the substantial risk of forfeiture lapses in the future when the stock has appreciated, then not only does the executive owe income tax on the income from the shares, but the company receives a tax deduction and is also required to pay the appropriate FICA and other withholdings. These are often overlooked and could result in considerable penalties and interest when caught down the road. Since payroll tax obligations are personal obligations of responsible financial executives and possibly directors, this area should not be overlooked.

The I.R.C. §83(b) election on the entire grant of stock even if the substantial risk of forfeiture restrictions have not lapsed, and consequent acceleration of the tax obligation, is particularly sensible in the context of an early stage business when the value of the stock is

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For a discussion of grants of restricted stock, see §§38:25 to 38:28.

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See §15:51.

believed to be low and therefore any income tax would be low or non-existent. In a later stage business, the executive simply may not have the cash to pay the income and payroll taxes no matter how beneficial the acceleration of this tax (and concomitant conversion of future appreciation from ordinary to capital gains rates). In such event, alternative compensation strategies involving stock options should be explored. Alternatively, the VC or the Target could loan the executive the funds to pay the tax. The terms of repayment can be generous, with low interest and little if any amortization until a change of control or executive departure from the Target, although this can cause the Target to recognize imputed interest income under I.R.C. §7872.[3]

Even if stock is granted outright, the Target may reserve the right to repurchase the stock at cost for a period of time. This, in effect, mirrors the vesting of stock options discussed in subsequent sections,[4] and, in effect, serves to assure that the executive remains with the Target for a certain period of time and possibly the company attains certain milestones as vesting conditions. A repurchase right is a substantial risk of forfeiture and results in the value of the stock being treated as compensation to the employee only when it lapses. Often the company will seek to be able to repurchase even vested shares upon the founder/executive's departure, this time at the fair market value. While the founder might say this deprives him or her of any future appreciation, and that is true, it also allows the company to have those shares in reserve to attract replacements.

15:54. Sale of stock

The Target may also consider selling stock outright to executives. Many believe that outright ownership which requires an executive to write a check better aligns the interests of management and the VC investors as they both have proverbial “skin in the game.” As in the case of the grant of stock, the sale of stock provides enormous tax advantages to the executive since it allows the executive to pay tax on any future gain at the long-term capital gain rates and, if applicable, perhaps the even the lower rate for qualified small business stock.

Sometimes, the Target or VCs will loan money to the management team to purchase the stock. If the terms are generous (i.e., at zero interest or below the IRS stated minimum applicable federal rate), the Target as lender may have imputed interest income.[1] If the loan is nonrecourse to the executive and recourse solely to the shares, the loan will be viewed as income to the executive since there is no meaningful personal obligation to repay. There is uncertainty as to what percentage of the loan must be recourse and what percentage non-recourse to avoid the IRS reclassifying the loan as compensation income. Some tax practitioners are aggressive and

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For a discussion of the taxation of loans by corporations to shareholders, see §25:24.

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See §§15:55 to 15:57.

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See §15:53.

suggest that at least 10% of the loan should be recourse. Many practitioners take the view that 50% of the loan needs to be recourse to the executive to avoid the loan being reclassified as all income to the executive.

If the initial purchase price for the stock is below fair market value (however determined), the bargain element will result in a current income tax to the executive.

15:55. Stock options

The most prevalent form of incentive compensation plan in VC-backed companies is an equity option plan. Options are typically issued in "C" corporations and not pass through entities. Options provide the executive the right to buy a finite amount of shares of the stock of the Target at a specific price for a specific time. Options provide executives with the best of both worlds. If the stock appreciates, they will presumably exercise some day and pocket the difference between the sale price and exercise price. If the stock value declines, they will not exercise in most circumstances and therefore risk nothing, except the opportunity to have worked at another VC-backed company whose stock may have appreciated.[1]

Stock options, however, can be very tax inefficient as they are often exercised and sold at or near the time of a change of control and therefore the gain is taxed at ordinary income rates. If the option holder departs from employment prior to a change of control, most options are required to be exercised, or forfeited, within three to six months of departure. That imposes a conundrum on the holder--do I exercise and hope for the best in a company in which I am no longer involved and there may not be transparency for when an exit may occur, not to mention having to come up with the funds to pay the strike price? Or do I let lapse my only hope for a major gain and which represented my rationale for taking less current compensation all those years?

Stock options are typically subject to vesting rules and other forfeiture provisions to attempt to assure that the recipient grantee remains with the Target for some period of time. Under vesting rules, the executive's right to the full value of the options is staggered and comes into effect only if he or she remains with the company. Vesting typically is based on the passage of time. Normally, there is a one year "cliff" before which time no vesting occurs. This time period gives the parties a chance to see how things work out before making any compensatory commitment. After that one year period elapses, options typically vest over a straight line, typical monthly or quarterly over three or four more years. Some vesting may also be predicated on the attainment of certain milestones, such as an FDA clearance or a financial performance hurdle. When milestones are a vesting component, the allocation between time based and performance based is typically 50-50 but there is no rule.

Stock options also provide for acceleration upon a change of control, with possible "double trigger" requirements, as discussed above in the section on restricted stock.

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For a discussion of stock options, see §§38:29 to 38:32.

Stock options are typically granted in consideration for the receipt from the employee of restrictive covenants (such as non-competition, non-solicitation, confidentiality and non-disclosure, non-disparagement and assignment of inventions agreements).

Stock option plans come in two varieties, and the distinctions between the two revolve largely around the income tax and accounting treatments. The two basic types of stock option plans are statutory or qualified option plans, sometimes called incentive stock options ("ISOs") and non-statutory or nonqualified options ("NSOs"), both discussed below.

Finally, stock options must be grated at a strike price (the price at which the option is exercised) at no less than fair market value. Income Tax code section 409A imposes significant penalties and interest for any grant below fair market value. Obviously, determination of fair market value is not precise and often subject to scrutiny in due diligence for investment rounds or upon IRS audit. The IRS has promulgated certain safe harbors to help insulate a business from this type of scrutiny. A prominent approach is to obtain a 409A valuation, basically an appraisal prior to or contemporaneous with the grant of options. Many small businesses are not enamored, however, with the cost associated with this expenditure, no matter how modest and how salutary. A thoughtful analysis by a board member who has considerable experience in valuation, investment banking, investments or other financial services is also a safe harbor, although the precise form of experience and valuation report is open to uncertainty. There are capitalization and record keeping services, like Carta, that bundle into their pricing models one 409A valuation per year.

15:56. Stock options: statutory options ("ISOs")

ISOs are available in "C" corporations but not for any entity, like an "S" corporation or partnership or LLC taxed as a partnership. An ISO plan, as a creature of the Internal Revenue Code, must meet certain statutory requirements to take advantage of the special tax and accounting benefits afforded such option plans. Specifically, the plan must provide that: (a) all options issued under such plan must be exercised no later than 10 years from the date of grant; (b) options covering no more than $100,000 of the stock of the issuing corporation (measured as of the date of grant) may become first exercisable by any individual employee in any given year; (c) the strike price may not be less than the fair market value of the underlying stock at the date of grant; and (d) the option must be strictly nontransferable. If an ISO is issued to an individual who owns more than 10% of the fully-diluted stock of the issuing corporation, the option must be exercised within five years of the date of grant and the strike price may not be less than 110% of the fair market value of the underlying stock at the date of grant.[1]

If these statutory requirements are met, the executive will not be subject to tax on the receipt of the ISO or upon its exercise. (However, if the executive is subject to the alternative minimum tax, the spread between fair market value of the stock and the strike price will be subject to AMT on exercise.) Rather, the executive will be subject to favorable long-term capital gains treatment on the disposition of the stock if the executive holds the stock for at least two

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See §38:32.

years from the date of the option grant and one year from the exercise date.[2] Of course, if the executive exercises the option due to the sale of the Target, the executive may not have the opportunity to hold the stock for the requisite capital gain holding period, and, therefore, the appreciation in the stock from the date of grant would be taxed at the higher ordinary income tax rates.

If the plan qualifies for favorable tax treatment to executives, there is no income tax deduction available to the Target in connection with maintaining such plan.

Because the option strike price is equal to the fair market value of the underlying equity, the Target will suffer no charge to its earnings for accounting purposes in connection with the maintenance of an ISO plan. This may be important to a VC investor in the Target if its exit strategy features the acquisition of the Target by a public company.

15:57. Stock options: non-statutory option plans ("NSOs")

As with an ISO plan, a non-statutory option ("NSO") plan provides executives with the right to purchase Target stock at a price and at a time established under the terms of the plan. The major difference is that the non-statutory plan is not subject to the strict statutory limitations and as a result may provide for a strike price that is less than the fair market value of the stock on the date of grant.[1] NSOs may also be utilized in an LLC taxed as a partnership whereas ISOs are only available in "C" corporations, although this author would prefer the grant of profits interests in an LLC taxed as a partnership rather than NSOs.

While the executive may benefit from receiving a grant of nonqualified stock options with a strike price below fair market value, the actual consequence to the executive, from a federal income tax standpoint, may be less desirable than an ISO. For instance, while the executive will have no income recognition upon the grant of a non-statutory option, he or she will recognize income at ordinary income tax rates and be subject to employment tax withholding requirements on exercise in an amount equal to the spread between the then fair market value of the stock and the strike price. On the flip side, the Target will have a corresponding income tax deduction for the spread.

Where there is an established market for the Target's options, the executive may make an election under I.R.C. §83(b) to accelerate the recognition of compensation income to the date of grant at a time when the spread between strike price and fair market value of Target stock may be relatively modest. However, generally speaking, no section 83(b) election will be available since it is very unlikely that the Target's options will be marketable, and, as a result, the ordinary income tax element associated with the non-statutory option will stay open until the exercise date.

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See §38:31.

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See §38:30.

Because of the compensation element recognized in a non-statutory option plan, the Target will suffer a charge to its earnings from time to time when executives exercise their options, equal to the spread between the option strike price and the stock's fair market value at the date of exercise.

15:58. Interests in entities taxed as partnerships

LLCs taxed as partnerships provide an attractive opportunity to grant equity interests to employees in exchange for services while requiring no payment from the employee for the interests while at the same time enabling the employee to reap the benefit of long-term capital gains rates if those interests appreciate and are held for more than one year. Profits interests require no upfront payment by the employee recipient since the strike price equivalent is set at the then fair market value of the Company. In other words, if the Company were then sold at the value imputed by the strike price, the interests would be worthless. Like options, the threshold or target amount may also be predicated upon attainment of certain milestones (such as if the fair market value doubles, the employee receives three times the number of units).

The employee should make an 83(b) election and the Board or whomever set the strike price (often called a threshold amount or equivalent) would be advised to conduct a 409A valuation or other third-party valuation as discussed in a previous section.

The profits interests are typically subject to vesting and repurchase rights as discussed above in previous sections. Further, like grants of options, profits interests are typically granted in consideration for the receipt from the employee of restrictive covenants (such as non-competition, non-solicitation, confidentiality and non-disclosure, non-disparagement and assignment of inventions agreements).

Profits interests provide benefits of ownership and beneficial tax treatment. These units however are securities. As such, the company's board owes the interest holder fiduciary duties (unless these are disclaimed and waived) and reporting obligations such as tax information and information rights. Although many of these information rights may be limited in the operating agreement of the company, most state laws provide for statutory requests for information and sometimes inspection rights which a member may seek upon reasonable notice. Caution is advised, therefore, prior to granting these units to small owners to avoid a larger group being conferred possibly adversarial ammunition. State law also typically confers dissenters' and appraisal rights on equity holders in a change of control transaction so the company should be sure to have these disclaimed and waived in the definitive documentation.

While LLCs can issue options to purchase membership interests that function like non-statutory stock options, only corporations can issue incentive stock options. The law relating to the taxation of interests in partnership entities that are substantially non-vested and therefore similar to restricted stock is in a state of flux.[1]

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See §8:12.

15:59. Phantom equity

If the Target wants to avoid giving employees an equity interest, stock appreciation rights ("SAR") and phantom stock plans can be used to provide them with similar incentives. These plans confer on recipients the right to enjoy their share of the appreciation of the value of the company over the value as of a certain date (typically the grant date). The recipient therefore receives the benefit of the appreciation in value of the business but is not out of pocket any cash to obtain the right nor is at risk for any decline in value of the business (except for the opportunity cost). As these phantom equity and SAR rights are not "securities," no fiduciary duties, information rights, voting rights, appearance on a capitalization table or other rights inherent in stock ownership are present.

Under these plans, which can be used by both corporations and LLCs taxed as partnerships, employees are rewarded if the value of the Target's value increases over predetermined thresholds.[1] To avoid an adverse initial tax impact on the issuance of these rights, the board should be careful in ascribing the threshold at the then fair market value of the common equity. From the employee's standpoint, these plans are less desirable than plans involving actual stock because an I.R.C. §83(b) election is not available to minimize the tax impact, and employees receive taxable compensation income equal to the full benefits paid at the time they are paid. Again, these grants may be conditioned on the delivery of restrictive covenants.

Another alternative is to establish a deferred compensation plan under which the amount received by the employee depends upon the attainment of certain business benchmarks. The eventual payout on such a plan is also treated as compensation income to the employee, but larger payments can be used to soften the impact. The requirements of I.R.C. §409A must be taken into account to not only ensure that the employee's compensation income is deferred but also that the employee is not subject to penalty taxes.[2] Likewise, a 409A valuation or similar contemporaneous determination of value should be conducted to respect both the employer and employee from being deemed to have underpaid payroll and income taxes.

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See §§38:33 to 38:34.

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See §§38:14 to 38:17.