ABC Corporation

Series D Preferred Stock

“Business” Terms

Pricing

Value per share; percent of company post-financing

Form of Investment

Preferred Stock; entrepreneurs get common, preferred has preference in liquidation, payment of dividends, protection against future dilution, but retains the same voting rights as if the investment were in common stock.

Special Rights

Right to put investment back to the company
Right of first refusal to purchase any future securities issued by company
Right to board seat (no merger or sale without preferred director(s) approval)
Right to acquire founder’s shares if company declines to purchase
Right to receive specified company information

Registration Rights (for SEC filing)

“Demand rights” -- ability to force company (to use its best efforts) to register stock for a public offering under certain conditions
“Piggyback” rights – ability to sell stock in a public offering that the company is initiating (either an initial public offering or a subsequent offering) under certain conditions
“Tag-along” rights – ability to join in a sale of stock (pro-rata) when founders or other major investors are selling less than all of the company

Other Conditions

Intellectual property developed by employees to remain company property
Company shall have right of first refusal on insider stock options

Termination

Most of these special rights terminate with (or soon after) an IPO
Some Business Terms That Were Absent in ABC

Negative Covenants:

- Use of proceeds from financing to be restricted
- Restrictions on issuance of debt or leases
- Restrictions on the payment of dividends

Benchmarks:

- Benchmarks (e.g., achieving sales or cash flow results) to be met to release funds for investment, or to adjust founder/employee ownership of company

Decision Making:

- Actions normally taken by the board of directors must be approved by investors.
- Supermajority voting rights available to investors.

Matters Related to Management

- Restrictions on amount of stock available for employees or consultants
- Investor approval required for appointments to certain management positions
  - Key Man life insurance
  - Employment contracts

“Drag-Along” Rights

- Ability to force other investors to join in a sale to a buyer the investor with these rights has found

Exclusivity and Break-up fees

- Company agrees to negotiate for a time with investors only
- Company agrees to pay a fee to investors if company withdraws from negotiations or does deal with another party
Main Control Features

Appointment of Management

Approval by investors
Voting at board of directors; Supermajority powers
Employment contracts and vesting
Control of intellectual property produced by employees

Transfer of Funds (Cash) Out of the Company

Dividends
Acquisition of other companies, properties
Stock repurchases

Dilution of Stock

New issues of shares or options
Management and employee stock option pool
Acquisitions

Control of Board of Directors

New appointments
Seats tied to new financing
Supermajority powers
Investors acting collectively to mass voting power

Access to Financing

Approvals required
Appointment of bankers
Frequency of financing, returning to markets

Shareholder’s Rights

Dividends and liquidation
Rights of first refusal and redemption (puts)
Registration rights
Conversion from preferred stock

Enforcement Provisions

State corporation law; contracts
Litigation
Economic powers of investors
“Control” Practices Used by VCs

Maximize percentage of company owned by VCs when in early rounds (greater voting control, better expected economic value)

Make financing rounds small so company will run out of money and have to come back for more, each time having to negotiate new terms

Syndicate deals so as to be able to invest as a “pack” with VCs cooperating with each other to maximize their voting power (also authenticates valuation of each round to have a newcomer come in the deal)

Restrict board seats severely to those they want there (other VCs and early investors)

Use access to information and board voting power (and the influence that confers) aggressively. For this to work well the VC must be highly familiar with the business and industry of the company and be able to offer constructive advice (this limits the fields into which VC may go)

Use access to VC “networks” to check the progress of company and anticipate the next set of problems.

Plan ahead to the next financing, anticipate exits and prepare in advance to take advantage of unexpected opportunities when they appear.
Oct 11:

Top to bottom analysis of New River

(a) as an investment prospect for VCs

(1) opportunity recognition
(2) economic potential
(3) management team
(4) executional difficulty
(5) problems to be anticipated

(b) as an opportunity for entrepreneurs

(1) “quit the day job?”
(2) rewards vs risks involved?
(3) working with the VCs
(4) problems to be anticipated

Oct 16:

Visit by CEO Larry Renfro