

Private Offerings: Finding the Right Balance of Power and Interests

December 8, 2010

Presented by:
Heidi M. Drivdahl
Bryce L. Holland



What is a “Typical” Private Offering?

- ◆ Company is a corporation (not an LLC or other form of entity)
- ◆ Founders have common stock
- ◆ Investors are buying preferred stock
- ◆ Company is in early stage of development – business plan likely to include additional later round(s) of financing (but not always)
- ◆ Total investment sought from investors in first round is usually between \$200,000 and \$2,000,000
- ◆ Number of investors could be very few (1 or 2) or many (usually not more than 20 or so)



Introduction to Deal Terms

◆ Three important areas to consider:

◆ **ECONOMIC** terms, including:



- ◆ Purchase price
- ◆ Liquidation preference
- ◆ Antidilution
- ◆ Dividends
- ◆ Redemption

◆ Issues relating to **CONTROL**, including:



- ◆ Board composition
- ◆ Protective provisions
- ◆ Corporate requirements for shareholder voting; cumulative voting

◆ Other **CONTRACTUAL** rights and obligations, including:



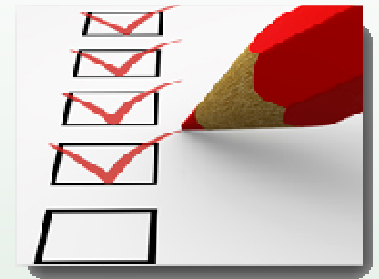
- ◆ Preemptive rights
- ◆ Information rights
- ◆ Right of first refusal and co-sale
- ◆ Registration rights
- ◆ Drag-along
- ◆ Pay-to-play



Transaction Documents Can be Overwhelming

- ◆ Preliminary offering documents usually include a business plan, financial projections, and an offering memorandum, or at least a term sheet describing the terms of the offering.

- ◆ Typically 5 key transaction documents:
 1. Purchase Agreement
 2. Investor Rights Agreement
 3. Voting Agreement
 4. Right of First Refusal and Co-Sale Agreement
 5. Articles of Incorporation





Economic – Valuation and Purchase Price

- ◆ Typically, purchase price per share = the company's pre-money valuation / shares outstanding. So, if the company's pre-money valuation is \$3M, and investors put in another \$500,000, the investors should end up with 14.29% of the company post-financing, right? (Math: $500,000 / 3,500,000 = 0.1429$)
- ◆ **NOT NECESSARILY!** It depends on whether the company included its *fully-diluted* capitalization in determining the per-share price. What about:
 - ◆ Outstanding options and remaining option pool
 - ◆ Warrants
 - ◆ Convertible securities (e.g., notes)
 - ◆ Other promises or obligations to issue securities



Example

Compare these pro forma capitalization tables:

Class	Shares	Percent
Common Stock	3,000,000	85.71%
Preferred Stock	500,000	14.29%
TOTAL	3,500,000	100.00%

Class	Shares	Percent
Common Stock	3,000,000	67.04%
Preferred Stock	500,000	11.17%
Option Pool	875,000	19.55%
Warrants	100,000	2.23%
TOTAL	4,475,000	100.00%



Economic – Liquidation Preference

- ◆ Liquidation preference is usually related to original purchase price of shares – sometimes a multiple
 - ◆ A right to receive a specified distribution upon sale of the company *prior* to distributions to common stock holders
 - ◆ “Non-participating” means all the investor gets is the liquidation preference amount
 - ◆ “Participating” means investors get the liquidation preference amount, *plus* a pro rata portion of any remainder to be paid to shareholders (after payment of any other liquidation preference amounts); sometimes subject to a cap
 - ◆ None for common stock



Liquidation Preferences Illustrated

Background:

- ◆ Company has 10 million shares common stock outstanding, and has issued 10 million shares of preferred stock at \$1.00 per share
- ◆ Company is sold for \$80,000,000



Example 1: No Participation

- ◆ Non-participating preferred stock with a 1X liquidation preference:

Preferred = \$10,000,000

Common = \$70,000,000

- ◆ In this scenario, **preferred** would convert to **common**, so the proceeds after conversion would be:

Preferred = \$40,000,000

Common = \$40,000,000



Example 2: Full Participation

- ◆ Full participating preferred with a 1X liquidation preference:
 - Preferred = \$45,000,000
 - Common = \$35,000,000
- ◆ Compare to the \$40 million outcome for common stock holders in the prior scenario; with full participation, preferred will always get its liquidation preference amount *more* than common stock



Example 3: Capped Participation

- ◆ 1X liquidation preference, plus participation until 3X is paid:

Preferred = \$30,000,000

Common = \$50,000,000

- ◆ In this scenario, common stock gets **all** of the **upside** for amounts in excess of \$50 million



Economic – Antidilution

- ◆ Preferred stock converts into common stock at an established ratio
- ◆ Antidilution provisions adjust the conversion ratio in the event of a subsequent lower-priced offering of stock:
Acts as a hedge against overpaying
- ◆ Most investor-friendly = **full ratchet**:
Knocks down the conversion price to the most recent price
- ◆ Company-friendly = **broad-based weighted average**:
Adjusts conversion price to give effect both to new price and to number of shares issued at new lower price, as a percentage of total capitalization



Economic – Dividends

- ◆ **Rate**: 8–10% fairly common
- ◆ **Current**: paid each year (not common)
- ◆ **Cumulative**: accrues, even if not declared and paid
- ◆ **Paid when?**
 - ◆ Prior to any dividend paid to common stock
 - ◆ Sometimes preference amount, and then “participation” with common on any dividends payable on common
 - ◆ Generally at liquidation or redemption



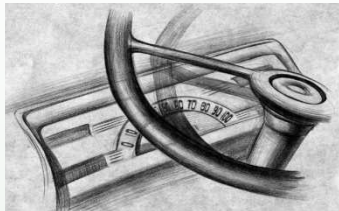
Economic – Right of Redemption

- ◆ Gives the investor the right to force the company to buy out the investment
- ◆ Price to include dividends?
- ◆ Usually kicks in after 5 or 6 years
- ◆ Not often used, as a practical matter, except as a tool to force a sale



Control – A Balancing Act

◆ Why care?



- ◆ There are many stakeholders in a company, often with very different motives and objectives, so it's important to know who is in the driver's seat (or who can block)
 - ◆ E.g., investors and founders may have very different economic interests in the company; if VCs are involved, they may have time-to-liquidity expectations different from other investors; strategic investors may have additional goals
- ◆ A founder/CEO can be ousted or replaced – relationships can shift and loyalties can change
- ◆ What results in a good return for one shareholder may result in a loss for another



Control – Board Composition

- ◆ Two ways to document right to appoint Board members:
 - ◆ In **Articles** – provides that a certain class of stock is the **only** class that has a right to vote on a particular Board seat
 - ◆ By **Contract** – a Voting Agreement requires shareholders to vote all their shares (of any class) for a Board member designated by a specific shareholder or group of shareholders
- ◆ Often used together



Board Composition is a Step, Not a Solution

- ◆ Board members are subject to fiduciary duties, and must act in their capacity as a director, and not as a shareholder, when considering Board actions
- ◆ Also consider “**interested director**” transactions – where the approval of two or more disinterested directors, or a majority of disinterested shareholders, is needed





Control – Shareholder Vote Requirements



- ◆ Pay attention to statutory vote requirements – WA default is two-thirds and separate class vote for amending Articles and sale of the company
 - ◆ May be more difficult to get shareholder approvals; may result in one or more blocking positions
 - ◆ Can opt out by providing language in Articles that reduce required vote to majority, and eliminate separate class voting



- ◆ DE default is majority vote; can opt out of separate class vote



Control – Protective Provisions

- ◆ Limitation on what the company can do without the approval of certain shareholders
- ◆ Examples of typical restrictions:
 - ◆ Liquidate, dissolve or wind-up the affairs of the Company, or effect any merger or consolidation
 - ◆ Amend, alter, or repeal any provision of the Articles or Bylaws in a manner adverse to the Series A Preferred
 - ◆ Authorize or issue any other security having rights, preferences or privileges senior to or on parity with the Series A Preferred, or increase the authorized number of shares of Series A Preferred
 - ◆ Purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred
 - ◆ Incur indebtedness of more than \$_____
 - ◆ Increase or decrease the size of the Board of Directors



Control – Cumulative Voting

- ◆ Default rule in WA – companies usually opt out in their Articles
- ◆ Gives minority shareholders more power in electing directors – allows shareholders to cast all their votes for a single nominee when the company has multiple openings
 - ◆ E.g., if election is for 4 directors, and you hold 500 shares, you would normally vote 500 shares for each of 4 candidates (total of 2,000 votes). With cumulative voting, you could choose to vote all 2,000 votes for one candidate, or 1,000 each to two candidates.
- ◆ Especially important where there is no voting agreement or provision for Board composition



Contractual Rights – Preemptive Rights

- ◆ A preemptive right, sometimes called a right of first offer, gives a shareholder first choice to participate in any new securities offering, typically up to the amount of their pro rata share (maintains same percentage ownership of the company)
 - ◆ The statutory default in WA, but usually opted out in Articles
 - ◆ Typically found in the Investor Rights Agreement
 - ◆ Important to understand:
 - ◆ How the preemptive right is calculated (based on outstanding shares only, or fully-diluted)
 - ◆ When it applies (what carve-outs are there – typically same as anti-dilution carve-outs)
 - ◆ What happens if the right is not exercised (is it use it or lose it?)
 - ◆ Whether there is a right of overallotment (if some shareholders don't exercise, can others take their share?)



Contractual Rights – Pay-to-Play

- ◆ Pay-to-play provisions penalize an investor who fails to invest in a future round of financing. There are 2 basic flavors:
 - ◆ **Traditional pay-to-play** provides for conversion into common stock of some or all of the preferred stock held by non-participating investors.
 - ◆ **Pay-to-play “light”** is where the preferred stock held by non-participating investors automatically converts into a new series of preferred stock with fewer rights and preferences (e.g., no antidilution protection).



Contractual Rights – Right of First Refusal and Co-Sale

- ◆ **Right of First Refusal** – when a shareholder is proposing to transfer shares, the company or other shareholders have the first right to acquire them on the same terms being offered
 - ◆ Typically only binds founders; sometimes investors are also bound
 - ◆ Typically only benefits investors; founders usually do not have a right to acquire shares being transferred
 - ◆ Carve-outs usually include for purposes of estate planning, and distributions to equity holders of entities
 - ◆ **Mechanics:** Company has first right of refusal, and if it doesn't acquire all the shares being transferred, shareholders or investors have the second right of refusal



Contractual Rights – Right of First Refusal and Co-Sale_{, cont.}

- ◆ **Co-Sale** – to the extent the right of first refusal is not exercised, allows other shareholders to participate in the sale
 - ◆ **Mechanics:** Those shareholders who want to sell shares get to substitute some of their shares for the selling shareholder's shares, on a proportional basis; reduces the number of shares the selling shareholder can sell



Contractual Rights – Information Rights

- ◆ WA Statute says:
 - ◆ Shareholders are entitled (upon notice) to inspect Articles, bylaws, shareholder meeting minutes and consents, annual financials, all communications to shareholders, and names and addresses of directors and officers
 - ◆ Shareholders may be entitled (upon notice and specification of proper purpose) to inspect excerpts of Board meeting minutes and other Board records, accounting records, and the shareholder list
- ◆ Typical contractual information rights reserved for major investors only, and include:
 - ◆ Quarterly and sometimes monthly financials
 - ◆ Budgets and business plans
 - ◆ Right to inspect all accounting records and to discuss all business affairs with officers



Contractual Rights – Information Rights, cont.

- ◆ Benefit vs. burden
 - ◆ May distract management team from more pressing issues; also added cost
 - ◆ If investors are represented on the Board, may be able to obtain same information at Board meetings
- ◆ Confidentiality
 - ◆ Shareholders (as opposed to directors, who have fiduciary obligations) may not be subject to confidentiality obligations
 - ◆ Standard carve-outs include information deemed to be a trade secret or confidential information (unless covered by a confidentiality agreement) or the disclosure of which would adversely affect the attorney-client privilege between the company and its counsel



Contractual Rights – Drag-along

- ◆ Drag-along means the obligation to **approve** and **participate** in a sale of the company or a sale of stock if certain conditions are met
 - ◆ Not common, but if high enough thresholds are met, may be in the best interests of all parties
 - ◆ Thresholds as to shareholder vote percentage required, including class votes, and sometimes purchase price
 - ◆ Ensures that a sale approved by most shareholders will go through (no dissenter's rights, no blocking votes)



Contractual Rights – Registration Rights

- ◆ Designed to provide liquidity to shareholders
- ◆ 3 types:
 - ◆ Demand – the right to force the company to register the shareholders' shares (can be either before or 180 days after the company's stock is already publicly traded)
 - ◆ S-3 – short-form registration statement; can only be used following first anniversary of IPO
 - ◆ Piggy-back – the right to include shareholders' shares in a registration statement filed for the benefit of the company or other shareholders



Contractual Rights – Registration Rights, cont.

- ◆ As a practical matter, may not be needed
- ◆ Unlikely shareholders will use demand registration rights to force an IPO
- ◆ After IPO, Rule 144 will probably be available to dispose of all the shares of most shareholders
 - ◆ One-year holding period
 - ◆ For affiliates only, additional volume and manner of sale requirements, but usually easily met



Balancing Act – How to Analyze a Deal

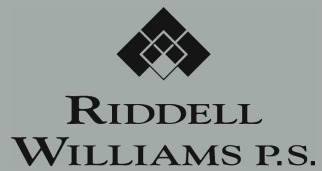


- ◆ Think about the particular circumstances
 - ◆ Where are the biggest risks in your deal?
 - ◆ How can you minimize that risk?
- ◆ Do you have adequate **economic** protections, or are you going to need to rely on **control** provisions?
- ◆ Are there other **contractual rights** that would make you feel more comfortable making an investment?



More Information

- ◆ National Venture Capital Association www.nvca.org
- ◆ Angel Capital Association
www.angelcapitalassociation.org



Questions?

Please contact us any time with additional questions

Bryce L. Holland

206.389.1737

bholland@riddellwilliams.com

Heidi M. Drivdahl

206.389.1796

hdrivdahl@riddellwilliams.com