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Raising Venture Capital Investments 101: Key Terms and Concepts for Your Early Stage Financing Deal

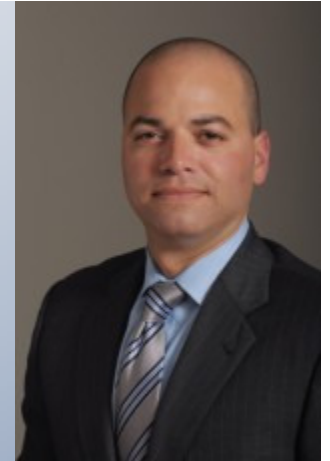
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LEGAL NOTICE

THIS PRESENTATION IS INTENDED TO PROVIDE GENERAL INFORMATION ON THE SUBJECT MATTER HEREIN AND SHOULD NOT BE CONSTRUED AS LEGAL ADVICE. A VENTURE CAPITAL INVESTMENT IS A COMPLEX UNDERTAKING. BEFORE ENTERING INTO SUCH A TRANSACTION, YOU SHOULD SEEK THE ADVICE OF EXPERIENCED LAWYERS, ACCOUNTANTS AND OTHER BUSINESS ADVISORS.

Mitchell C. Shelowitz

Partner



- Business lawyer with more than 19 years of experience representing U.S. and international businesses in the full range of corporate and commercial legal matters – from corporate deals to dispute resolution. More than 12 years of venture capital investment transaction experience on investor and portfolio company sides.
- Named as a New York Super Lawyer in 2010 for the fourth time, being recognized as one of the best business lawyers in New York City, and placing him in the top 5% of the profession.
- Top Law Firm Experience
 - Greenberg Traurig; Nixon Peabody; Proskauer Rose

Objectives of Program

- ❖ To provide essential insight for entrepreneurs, business executives, and business advisors involved in venture capital financing in today's markets.
- ❖ Topics covered will include the following:
 - ❖ Overview of the venture capital investment process
 - ❖ Descriptions of common venture capital deal terms
 - ❖ Essentials of venture capital term sheets
 - ❖ Summary of venture capital transaction documents
 - ❖ The importance of intellectual property assets in venture capital transactions

Roadmap of Program

- (1) Introduction
- (2) Overview of Venture Capital Deal
- (3) Top 5 Critical Deal Terms
- (4) Questions and Answers
- (5) Conclusion

Recent Venture Capital Highlights

- (1) PWC and National Venture Association announced YESTERDAY that VC activity increased 19 percent in Q2 2011 compared to Q1 2011
- (2) \$7.5 billion in 966 deals in Q2 2011
- (3) Internet Investments at 10 year high
- (4) Venture Funds from around US are opening offices in New York City (New Enterprise Associates; Accel Partners; Canaan Partners)
- (5) Investments are in early rounds and senior rounds

Overview of The Successful Venture Deal

- (1) Presentation of Business Plan to Investors
- (2) Initial Meetings and Initial Due Diligence
- (3) Delivery of Term Sheet by Investor
- (4) Negotiation and Signature of Term Sheet
- (5) Deeper Due Diligence by Investors
- (6) Negotiation of Investment Documents
- (7) Closing -- Transaction Documents Signed and Money and Shares Exchanged

** Venture deals may break off prior to completing any of these stages*

Standard Issues to Consider

- (1) Limited liability company vs. Corporation
- (2) Primary office location
- (3) Interim bridge financing (promissory notes)?
- (4) Who signs term sheet for company (who is founder?)
- (5) How much capital is required?
- (6) How will capital be used?

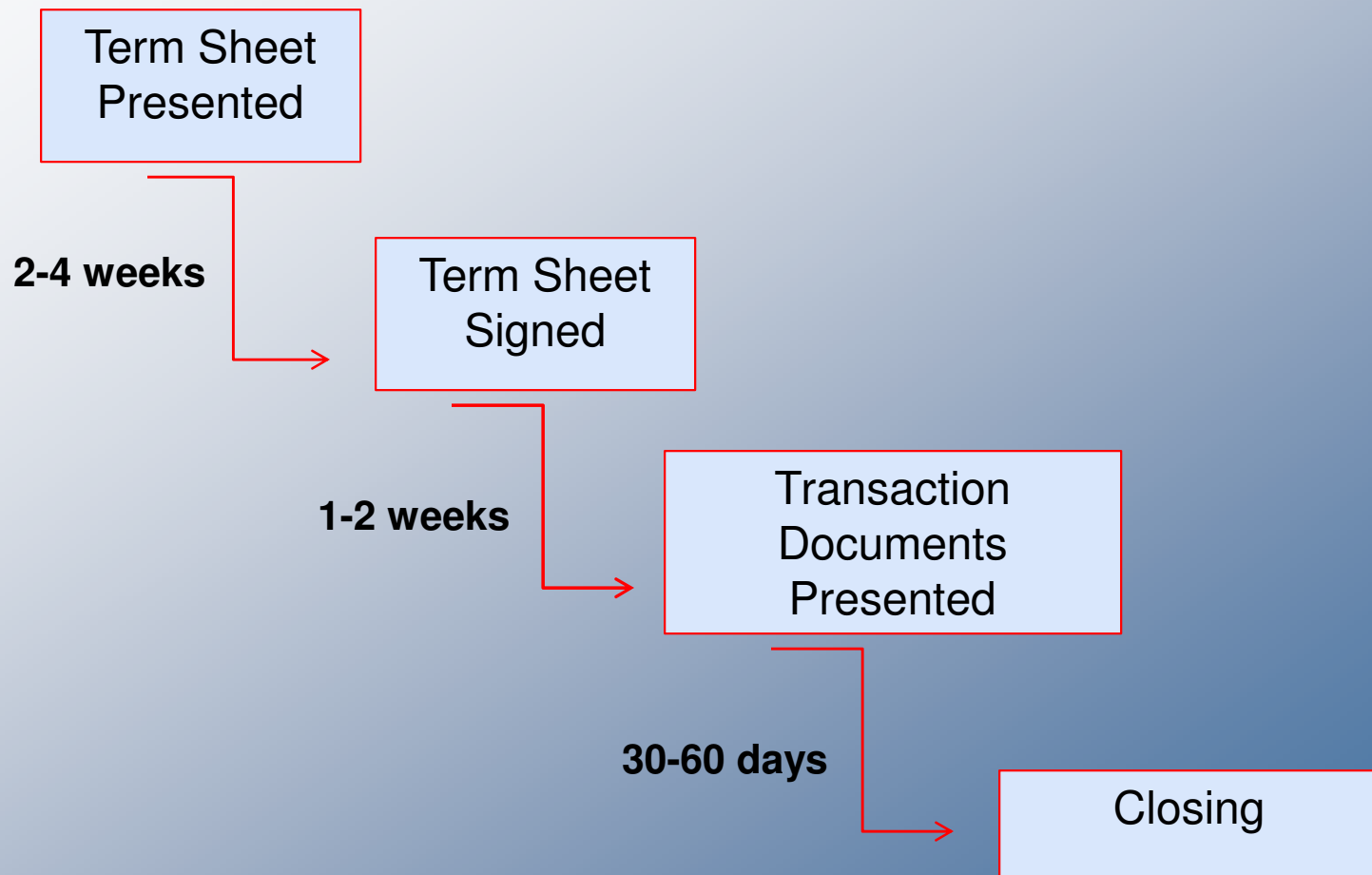
Importance of Term Sheet

- The Venture Investment Begins with a Term Sheet
 - Sets forth key business terms
 - Term Sheet negotiations provide window to both sides
 - Provides Venture Fund with opportunity to assess leadership, judgment, and sophistication of founders
 - Test for compatibility with business culture
 - The National Venture Capital Association has standard template which is helpful reference

The Venture Deal: Customary Transaction Documents

- (1) Purchase Agreement (Stock or Unit)
- (2) Amended and Restated Certificate of Incorporation/
Operating Agreement
- (3) Investors' Rights Agreement
- (4) Right of First Refusal and Co-Sale Agreement
- (5) Key Employee Employment Agreement (including non-competes)
- (6) Intellectual Property Assignment Agreement
- (7) Board and Shareholder Resolutions
- (8) Officer Certificates

The Venture Deal: Sample Timeline



** These timelines are examples only and may deviate from deal to deal*



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Venture Capital Term Sheets 101

Your Top 5 Critical Deal Terms



Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

- Venture Capital Term Sheets are Complex
 - contain numerous complex business and legal terms
 - provisions may vary by investor preference
 - each provision deserves a separate seminar
- Goal of this Summary
 - to familiarize you with key customary terms
 - to facilitate a successful transaction with investors
- Venture Capitalist's Goal
 - to earn a significant return on investment on Exit
 - M&A or Qualified IPO

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

1. Reverse Vesting of Founder Stock (Mandatory Minimum Employment Period)

- Stock owned by Founder may be forfeited
- Investors typically expect 5 year commitment
- Reverse vesting would result in forfeiture of percentage of founder's stock for departure from company months or years prior to completion of minimum employment period
- Often qualified if departure "for cause," "without cause", by resignation with or without "good reason"
- Founders hate this provision, but it is typically a deal breaker for the investors

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

2. Funding Model – One Payment or Multiple Payments

Various Approaches Limited by Investors' Creativity

- ✓ *Initial Financing by Convertible Promissory Note*
(convertible on qualified equity round)
- ✓ *Full Funding at Initial Closing*
- ✓ *Tranche-Based Investing based upon Milestones* – initial funding amount at closing followed by additional funds
 - ✓ Technological Achievement Based (Prototypes, Commercial Production, Beta launch, etc.)
 - ✓ Commercial Penetration Based (contracts signed, purchase orders received, invoices mailed)
 - ✓ Revenue Based (upon reaching revenues of \$X)

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

3. Liquidation Preferences and Redemption

The Liquidation Preference is the Heart of the Investor's Incentive to Invest –

(a) Types of Preferences

- (i) Non-Participating
- (ii) Participating (most common) (also referred to as **“Double Dipping”**)

(b) Multiples

- (i) 1X
- (ii) 2X-4X

(c) Exercise of Preference

- (i) Upon Liquidation Event (liquidation, M&A)

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

3. Liquidation Preferences and Redemption (cont'd)

Redemption – Allows Investor to force repurchase by Company of stock after certain period of time if no liquidation event or Qualified IPO occurs

- (a) Redemption Right Exercisable – us. after 5-7 years
- (b) Original purchase price plus accrued dividends
- (c) May be exercisable in one transaction or several
- (d) Usually not negotiable

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

4. Board Composition and Protective Provisions

- What is agreed size of Board of Directors?
- How many seats are held by Investors?
- Do Founders Retain Veto Power on Any Issues?
e.g., creative control of company, concept, markets?
- How involved will Board be with day to day operations?
- Board usually comprised of uneven number.

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

4. Board Composition and Protective Provisions (cont'd)

Investors have veto right over Company initiatives, including (but not limited to):

- (i) liquidations, dissolutions, and any Deemed Liquidation Events;
- (ii) amendments to Certificate of Incorporation or Bylaws;
- (iii) issuance of additional equity or debt;
- (iv) purchasing or redeeming or paying dividends on stock prior to the Series A Preferred;
- (v) increase or decrease the size of the Board of Directors;
- (vi) modifying the approved budget.

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

5. Conversion and Anti-Dilution Protection

Critical Sections – Complex

Conversion of Preferred Stock to Common occurs either:

- (i) under mandatory condition; e.g., qualified IPO; or
- (ii) as of right by investor option (on vote of agreed majority of Investors)

Conversion is based upon “original issue price” subject to adjustments to “conversion price”

Preferred Rights relinquished by Investors on Conversion

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

5. Conversion and Anti-Dilution Protection (cont'd)

Anti-Dilution Protection: comes into play in the event that in a subsequent financing round the price per share is lower than in the current investment (a “down round”).

Avoids reduction in Investor’s equity holdings

Two primary alternatives (Depend on Investors’ Demand):

(a) “Full Ratchet” – adjusts conversion price based upon price per share of down round regardless of number of new shares issued– *hardest for founders*

(b) “Weighted Average” – adjusts conversion price based upon number of new shares issued at lower price, based on customary formula

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

BONUS #1: The Lawyer's Role in Venture Deals

- To “translate” complex terms and explain “real” impact
- To expedite pace of transaction
- To help company to build relationship with investors
- To act as bridge between investors and company
- To keep comments on documents to a minimum

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

BONUS #2: Type of Stock/Units to be Purchased by Investors

1. Common vs. Preferred
2. Series of Stock Upon Conversion of Preferred:
 - (a) Single class of common; or
 - (b) New class of common with preferential voting, or other additional rights

Top 5 Critical Deal Terms

1. **Reverse Vesting of Founder Stock (Mandatory Minimum Employment Period)**
2. **Funding Model – One Payment or Multiple Payments**
3. **Liquidation Preferences and Redemption**
4. **Board Composition and Protective Provisions**
5. **Conversion and Anti-Dilution Protection**

BONUS #1: The Lawyer's Role in Venture Deals

BONUS #2: Type of Stock to be Purchased by Investors

Venture Capital Term Sheets 101: Your Top 5 Critical Deal Terms

 QUESTIONS?

Summary of Program

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Thank You

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