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venture deals

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Chapter 11

Issues at Different Financing Stages

Not all financings are created equal. This is especially true when you factor in the different stages that your company will evolve through over its lifetime. Each financing stage—seed, early, mid, and later stage—has different key issues to focus on.

Seed Deals

While seed deals have the lowest legal costs and usually involve the least contentious negotiations, seed deals often allow for the most potential mistakes. Given how important precedent is in future financings, if you reach a bad outcome on a specific term, you might be stuck with it for the life of your company. Ironically, we've seen more cases where the entrepreneur got too good a deal instead of a bad one.

What's wrong with getting great terms? If you can't back them up with performance when you raise your next round, you may find yourself in a difficult position with your original investor. For example, assume you are successful getting a valuation that is significantly ahead of where your business currently is. If your next round isn't at a higher valuation, you are going to be diluting your original shareholders—the investors who took a big risk to fund you during the seed stage. Either you'll have to make them whole or, worse, they'll vote to block the new financing. This is especially true in cases with unsophisticated seed investors who were expecting that, no matter what, the next round price would be higher.

Early Stage

As with seed deals, precedent is important in early stage deals. In our experience, the terms you get in your first VC-led round will carry over to all future financings. One item that can haunt you forever is the liquidation preference. While it may not seem like a big deal to agree to a participating preferred feature given that most early stage rounds aren't large dollar amounts, if you plan to raise larger rounds one day, these participation features can drastically reduce return characteristics for the common stockholders.

Another term to pay extra attention to at the early stage is the protective provisions. You will want to try to collapse the protective provisions so that all preferred stockholders, regardless of series, vote together on them. If by your second round of financing you are stuck with two separate votes for protective provisions, you are most likely stuck with a structure that will give each series of stock a

separate vote and thus separate blocking rights. This can be a real pain to manage when you have multiple lead investors in multiple rounds that each have their own motivations to deal with.

Mid and Late Stages

Later stage deals tend to have two tough issues—board and voting control. The voting control issues in the early stage deals are only amplified as you wrestle with how to keep control of your board when each lead investor per round wants a board seat. Either you can increase your board size to seven, nine, or more people (which usually effectively kills a well-functioning board), or more likely the board will be dominated by investors. If your investors are well behaved, this might not be a problem; but you'll still be serving a lot of food at board meetings.

There isn't necessarily a good answer here. Unless you have massive negotiating power in a super-hot company, you are likely to give a board seat to each lead investor in each round. If you raise subsequent rounds, unless you've worked hard to manage this early, your board will likely expand and in many cases the founders will lose control of the board.

The Entrepreneur's Perspective

There are ways to mitigate issues of board and voting control, such as placing a cap (early on) on the number or percentage of directors who can be VCs as opposed to independent directors, preemptively offering observer rights to any director who is dethroned, or establishing an executive committee of the board that can meet whenever and wherever you'd like without everyone else around the table.

The last thing to consider is valuation. Much like issues that we've seen in seed deals, there have been some deals that have been too good and have forced the VCs to hold out for a huge exit price. The net effect was that by raising money at such a high valuation, the entrepreneurs forfeited the ability to sell the company at a price they would have been happy with, because of the inherent valuation-creation desires of the VCs who paid such a high price.

Other Approaches to Early Stage Deals

We've spent a lot of time on classic preferred stock financings, but there are other options. Over the past few years we've seen the proliferation of *seed preferred* or *light preferred* term sheets as well as the use of *convertible debt* in seed and early stage deals. Let's take a quick look at these.

In a seed or light preferred deal, the parties are agreeing to a class of preferred stock that doesn't have all the protections and rights that typical preferred shareholders have. Why would investors agree to this? Well, for one, the company may be raising money from angel investors who don't require things like a board seat or protective provisions. In fact, it might not be appropriate given their financial

commitment for these investors to have these rights.

Due to IRS tax regulation 409A (Section 409A is an IRS rule that we will discuss later), you don't want to sell common stock to investors; otherwise, you'll peg the price of your common stock at a higher valuation than you want. Since you want to incentivize your early employees by granting them low-priced common stock options, a light preferred deal is a way to sell stock to investors while maintaining a low regular common stock price with which to grant stock options.

Another popular structure in seed deals is convertible debt. In fact, many angel investors will invest only with this structure. Convertible debt is just that: debt. It's a loan. The loan will convert to equity (preferred stock, usually) at such time as another round is raised. The conversion usually includes some sort of discount on the price to the future round.

For example, assume you raise $500,000 in convertible debt from angels with a 20 percent discount to the next round, and six months later a VC offers to lead a Series A round of a $1 million investment at $1.00 a share. Your financing will actually be for $1.5 million total, although the VCs will get 1 million Series A shares ($1 million at $1.00 per share) and the angels will get 625,000 Series A shares ($500,000 at $0.80 per share). The discount is appropriate, as your early investors want some reward for investing before the full Series A financing round comes together.

Most fans of convertible debt argue that it's a much easier transaction to complete than an equity financing. Since no valuation is being set for the company, you get to avoid that part of the negotiation. Because it is debt, it has few, if any, of the rights of preferred stock offerings and you can accomplish a transaction with a lot less paperwork and legal fees. Note however, the legal fee argument is less persuasive these days with the many forms of standardized documents. A decade ago there could be a $50,000 pricing difference for legal fees between a seed preferred round and a convertible debt round. These days the difference is between $0 and $10,000 since many lawyers will heavily discount the seed preferred round to get future business from the company.

The debate goes on endlessly about which structure is better or worse for entrepreneurs or investors. We aren't convinced there is a definitive answer here, but are convinced that those who think there is a definitive answer are wrong.

Since investors usually drive the decision whether to raise an equity or a debt round, let's look at their motivations first. One of the primary reasons for an early stage investor to purchase equity is to price the round. Early stage investing is a risky proposition and investors will want to invest at low prices, although smart investors won't invest at a price where founders are demotivated. As a result, most early stage deals get priced in a pretty tight range.

With a convertible debt structure, the price is not set and is determined at a later date when a larger

financing occurs. By definition, if there is a later round the company must be doing something right and the valuation will be higher. Having a discount is nice, but the ultimate price for the early convertible debt investors may still be more than they would have paid if they had bought equity. Some investors have been trying to fix this problem by setting a *cap* on the price they will pay in the next round. In other words, as an investor, I'll take a 20 percent discount on the price of the next round up to a valuation of $X. If you get a valuation above $X, then my valuation is $X (hence the notion of a "capped limit on the price").

This sounds like it fixes the problem, right? Maybe not. First of all, the investors coming into the next round may not like the idea that they are paying that much more than the convertible debt investors paid. Unlike equity, which is issued and can't be changed, the new equity investors could refuse to fund unless the debt investors remove or change the cap.

From the entrepreneur's standpoint, the choice isn't clear, either. Some argue that the convertible debt structure by definition leads to a higher ultimate price for the first round. We won't go as far as to say they are right, but we can see the argument that with a convertible debt feature you are allowing an inflated price based on time to positively impact the valuation for the past investors. We'd argue that this is missing half of the analysis in that a founder's first investors are sometimes the most important. These were the people who invested in you at the riskiest stage before anyone else would. You like them, you respect them, and you might even be related to them. Assume that you create a lot of value along the way and the equity investor prices the round at a number that is higher than even you expected. Your first investors will own less than anyone anticipated. At the end of the day, your biggest fans are happy about the financing, but sad that they own so little.

But does it really set a higher price? Let's go back to the example of a convertible debt round with a cap. If we were going to agree to this deal, our cap would be the price that we would have agreed to in an equity round. So, in effect, you've just sold the same amount of equity to us, but we have an option for the price to be lower than we would have offered you since there are plenty of scenarios in which the equity price is below the cap amount. Why on earth would I agree to a cap that is above the price that I'm willing to pay today? The cap amounts to a ceiling on your price.

The Entrepreneur's Perspective

To attract seed stage investors, consider a convertible debt deal with two additional features: a reasonable time horizon on an equity financing and a forced conversion if that horizon isn't met, as well as a floor, not a ceiling, on the conversion valuation.

There's also some dissonance here since VCs spend a lot of their time valuing companies and negotiating on price. If your VC can't or won't do this, what is this telling you? Do you and the VC have a radically different view of the value proposition you've created? Will this impact the relationship

going forward or the way that each of you strategically thinks about your company?

One final issue with convertible debt is a technical legal one. You'll have to forgive us, but Jason is an ex-lawyer and sometimes we can't keep him in a box.

If a company raises cash via equity, it has a positive balance sheet. It is solvent (assets are greater than obligations), and the board and executives have fiduciary duties to the shareholders in the efforts to maximize company value. The shareholders are all the usual suspects: the employees and VCs. Life is good and normal.

However, if a company is insolvent, the board and company now owe fiduciary duties to the creditors of the company. By definition, if you raise a convertible debt round, your company is insolvent. You have cash, but your debt obligations are greater than your assets. Your creditors include your landlord, anyone you owe money to (including former disgruntled employees), and founders who have lawyers.

How does this change the paradigm? To be fair, we have had no personal war stories here, but it's not hard to construct some weird situations.

Let's look at the hypothetical situation.

Assume the company is not a success and fails. In the case of raising equity, the officers and directors only owe a duty to the creditors (e.g., your landlord) at such time that cash isn't large enough to pay their liabilities. If the company manages it correctly, even on the downside scenario creditors are paid off cleanly. But sometimes it doesn't happen this way and there are lawsuits. When the lawyers get involved, they'll look to try to establish the time in which the company went insolvent and then try to show that the actions of the board were bad during that time. If the time frame is short, it's hard to make a case against the company.

However, if you raise debt, the insolvency time lasts until your debt converts into equity. As a result, if your company ends up failing and you can't pay your creditors, their ability for a plaintiff lawyer to judge your actions has increased dramatically. And don't forget, if you have any outstanding employment litigation, all of these folks count as creditors as well.

The worst part of this is that many states impose personal liability on directors for things that occur while a company is insolvent. This means that some states will allow creditors to sue directors personally for not getting all of the money they are owed.

Now, we don't want to get too crazy here. We are talking about early stage and seed companies,

and hopefully the situation is clean enough that these doomsday predictions won't happen; but our bet is that few folks participating in convertible debt rounds are actually thinking about these issues. While we don't know of any actual cases out there, we've been around this business long enough to know that there is constant innovation in the plaintiff's bar as well.