NEGOTIATING THE TERMS OF A VENTURE CAPITAL FINANCING: KEY CONCEPTS FOR ENTREPRENEURS

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It's not easy in the present economic climate for an entrepreneur to obtain venture capital financing. Entrepreneurs who succeed in obtaining a commitment from a venture capital firm face one additional hurdle: negotiating the terms of the financing with their fund sponsors. This Article outlines some of the key commercial and legal terms with which an entrepreneur should be familiar to succeed in that negotiation.

PRE-MONEY VALUATION. The valuation accorded to the company is critical because it determines the relative ownership interest of the entrepreneur and the venture capitalist. The valuation is typically expressed in "pre-money" terms, which describes the value of the company *prior* to being funded. The percentage interest of the venture capitalist in the company on a going-forward basis is a function of the funding that the venture capitalist provides the company and the pre-money valuation of the company.

Example 1. Assume the company is accorded a "pre-money" value of $4 million. If the venture capitalist provides $4 million of capital, the company will have a "post-money" value of $8 million ($4 million pre-money plus $4 million of funding). The venture capitalist will expect an ownership interest of 50%, representing his funding ($4 million) divided by the company's post-money value ($8 million). The balance of the equity interest (50%) will be retained by the founders.

One common source of misunderstanding in a financing is which party bears the dilution resulting from a management option pool. Entrepreneurs should seek to identify and resolve this issue early in negotiations. The ideal resolution from an entrepreneur's perspective is for the dilution stemming from management stock options to be borne pro rata by all shareholders, including the venture capitalist.

LIQUIDATION PREFERENCE. Venture capitalists typically provide funding in exchange for preferred stock. The key attribute of preferred stock is that it has priority over the common stock (typically owned by founders) when the assets of a company are distributed in liquidation (the liquidation preference is generally also payable upon the sale of the company, a so-called "deemed liquidation"). No liquidating distribution can be made with respect to common stock until the preferred stock has received its liquidation preference. The liquidation preference thus provides downside protection to the venture capitalist.

The liquidation preference can be either fixed or participating. A fixed preference is limited, and is typically equal to the purchase price plus accrued dividends (although in some circumstances it can be a multiple of the purchase price). A participating preference entitles the preferred stock to a specified dollar amount of liquidation proceeds, and the right to share (or participate) with the common stock in the remaining assets of the company on an as-converted basis. The participating preferred is a more attractive security for the venture capitalist because it features downside protection (the fixed liquidation preference) and upside potential (the right to participate in assets remaining after payment of the fixed liquidation preference).

Example 2. Assume the company is about to be liquidated and has $1,000 in assets. It has outstanding 100 shares of nonconvertible Series A Preferred Stock (note that preferred stock is almost always convertible, but has been assumed to be nonconvertible in this example for illustrative purposes) and 100 shares of Common Stock. The Series A Preferred Stock was purchased for $2 a share and has a 1x purchase price liquidation preference. Upon liquidation, each share of Series A Preferred Stock would receive $2 (or $200 in total, representing 1x purchase price), and each share of common stock would receive $8 per share (or $800 in total, representing $800, the assets remaining after payment of the liquidation preference, divided by 100, the outstanding shares of Common Stock).

Example 3. Same facts as Example 2, but the Series A Preferred Stock is a convertible participating preferred that participates with the Common Stock on an as-converted basis after receiving a fixed preference of 1x purchase price. Each share of Series A Preferred Stock is convertible into 1 share of Common Stock. Upon liquidation, each share of Series A Preferred Stock would receive $6 (or $600 in total) (reflecting a fixed preference of $2 and a participating preference of $4, which is $800, the assets remaining after payment of the fixed liquidation preference, divided by 200, the number of total outstanding shares on an as-converted basis), and each share of Common Stock would receive $4 per share (or $400 in total) ($400 divided by 100 outstanding shares of Common Stock).

If the entrepreneur cannot avoid granting a participation right to preferred stock, she should at least seek to cap the participation right, which reduces the upside potential of the preferred stock, and preserves more upside potential for the entrepreneur. She should point out that the management team is likely to lose motivation if its upside potential becomes relatively meager.

Example 4. Same facts as Example 3, except that the participation right of the Series A Preferred Stock is capped at 1x purchase price. Upon liquidation, each share of the Series A Preferred would receive $4 (or $400 in total) (reflecting a fixed preference of $2 and a participating preference of $2, which is $800, the assets remaining after payment of the fixed liquidation preference, divided by 200 total outstanding shares, capped at $2, 1x the purchase price of each share of Series A Preferred Stock), and each share of Common Stock would receive $6 (or $600 in total) (rep-

resenting $600, the amount remaining after payment of the fixed and participating liquidation preference on the Series A Preferred Stock, divided by 100 outstanding shares of Common Stock).

CUMULATIVE DIVIDENDS. Venture capitalists typically do not expect their portfolio companies to pay current dividends. However, venture capitalists often require that the preferred stock that they purchase feature a dividend. Back in the dot-com bubble era, dividends were generally payable when, as and if declared by the board of directors. Today, dividends are typically cumulative or accruing. This term means that the dividend accrues (or cumulates) even if not paid, and is (typically) paid only upon an exit event such as a redemption or liquidation. An accruing or cumulative dividend will often compound, so that the base for the dividend in a particular period includes the face value of the preferred stock plus accrued but unpaid dividends from prior periods.

The purpose of a dividend provision is to increase the amount that the preferred stock receives in preference to the holders of common stock, to include not only the purchase price of the preferred stock but also a built-in return on that purchase price. The cumulative dividend provision thus serves much the same purpose as a fixed liquidation preference. Entrepreneurs should seek to avoid duplication by making sure that the cumulative dividend is offset against the fixed liquidation preference. For example, instead of agreeing to a preferred stock that features a 8% compounding cumulative dividend and a separate 2x purchase price fixed liquidation preference, entrepreneurs should seek to ensure that the fixed liquidation preference is the *greater* of (a) 1x purchase price plus a 8% compounding cumulative dividend, or (b) 2x purchase price. The alternative formulation assures the venture capitalist a fixed preference of 2x purchase price, but spares the entrepreneur from paying an incremental preference equal to a 8% compounded cumulative dividend.

CONVERTIBILITY. Another important feature of preferred stock is that it is typically convertible into common stock. Preferred stock with a fixed liquidation preference has downside protection, but has a limited ability to share in the growth of a company if it succeeds. Convertibility provides the preferred stock with upside potential, by allowing the holder to convert it into common stock when the success of the company makes downside protection unimportant. Note that there is generally no incentive for a holder of preferred stock with a participation right to convert, as that security already features upside potential (unless, as explained above, the participation right is capped). The term conversion ratio refers to the ratio at which preferred stock converts to common stock.

Example 5. The company has outstanding 100 shares of Series A Preferred Stock and 100 shares of Common Stock. The Series A Preferred Stock was purchased at $2 a share and has a 1x purchase price fixed liquidation preference. The Series A Preferred Stock is nonconvertible (once again, preferred stock is almost always convertible, but has been assumed to be nonconvertible here for illustrative purposes). The company has $10,000 of assets. Upon liquidation, each holder of Series A Preferred Stock receives $2 ($200 in total, reflecting a 1x purchase price liquidation preference), and each share of Common Stock receives $98 per share ($9,800, the assets remaining after payment of the liquidation preference, divided by the 100 outstanding shares of Common Stock).

Example 6. Same facts as Example 5, but each share of the Series A Preferred Stock is convertible into 1 share of Common Stock. At liquidation, the holders of Series A Preferred Stock would exercise their conversion right and would hold 100 shares of Common Stock, so that there would be a total of 200 shares of Common Stock outstanding at liquidation. Each share of Common Stock (including the shares of Common Stock issued upon conversion of the Series A Preferred Stock) would receive $50 in liquidation ($10,000 divided by 200 outstanding shares of Common Stock). In comparison to Example 5, the convertibility of the Series A Preferred Stock has shifted $48 per share of liquidation proceeds from the holders of Common Stock to the holders of Series A Preferred Stock.

Example 7. Same facts as Example 6, but the Series A Preferred Stock participates above a 1x fixed liquidation preference, and each share of Series A Preferred Stock is convertible into one share of Common Stock. At liquidation, each share of Series A Preferred Stock would receive $51 ($2 of 1x purchase price fixed liquidation preference, plus $49 of the participating preference, representing $9,800 remaining after payment of the fixed liquidation preference divided by 200 shares on an as-converted basis), and each share of Common Stock would receive $49 ($9,800 divided by 200 shares). In comparison to Example 6, the participation right of the Series A Preferred Stock results in an additional benefit of $1 per share at liquidation to holders of that security.

DOWN ROUND. This term refers to a subsequent round of financing of a company in which the *pre*-money valuation of the company is *lower* than the *post*-money valuation of the company in the previous round of financing.

Example 8. The post-money valuation of the company after its Series A financing was $5 million. The pre-money valuation of the company at its Series B round is $3 million. The Series B round of financing represents a "down round" and the holders of Series A Preferred Stock have suffered a decline (or dilution) in the value of their security.

ANTIDILUTION PROTECTION. To protect against down rounds, venture capitalists typically negotiate for antidilution protection. The purpose of antidilution protection is to put an investor in a previous round in the same position that such investor would have been had such investor purchased its securities at a price analogous to that paid by investors in the subsequent down round. Antidilution protection operates by adjusting the conversion ratio of the prior round preferred stock so that such preferred stock is convertible into a greater number of shares of common stock than it would otherwise have been (in other words, it is as if the previous round investor had repriced the shares it originally pur-

chased; the extent of the repricing depends on the antidilution protection method chosen).

There are two basic methods of antidilution protection: weighted-average and full-ratchet. Entrepreneurs do not need to master the distinctions between these methods; what they should know is that the weighted-average method of antidilution protection is more favorable to the founders of a company because the adjustment it generates is a function of the economic dilution suffered by investors in earlier rounds. Full-ratchet antidilution protection, by contrast, produces an adjustment based solely on the price at which securities are issued in a subsequent round, and disregards the number of securities issued in that round, thus potentially overadjusting for the down round.

In addition, there are two variations on the weighted-average method -- broad-based and narrow-based. The former method is more favorable to founders because it takes into account all securities, even those that are not yet issued, such as options and convertible bridge notes. The latter method is less favorable to founders because it only takes into account outstanding securities, and thus results in a larger increase in conversion ratio.

As noted above, these concepts are fairly complex and a detailed explanation of them is beyond the scope of this Article. However, what entrepreneurs should take away from this discussion is that the most favorable antidilution method from their perspective is the broad-based weighted average method.

Pay to Play (or Play or Lose). These terms refer to a technique that is used to encourage investors in previous rounds of financing to participate in subsequent rounds, even if such rounds are down rounds. The technique operates by *requiring* investors that do not participate in subsequent down rounds to convert their shares of preferred stock into a special class of preferred stock (or alternatively into common stock). The consequence of such a conversion is that the investor in question loses the benefit of the antidilution protection of the preferred security that it originally purchased (and, if converted into common stock, the investor also loses the benefit of a liquidation preference). If they can, entrepreneurs should seek to include such a provision in their financing documents, as it increases the likelihood that their investors will continue to fund them in lean times.

This Article has described the key concepts in a venture capital financing. There are many other relevant terms, but a full description of all such terms is beyond the scope of this Article. Familiarity with the key concepts described and illustrated above will help the entrepreneur to safeguard his or her interests and lead to a set of terms that will appropriately balance the legitimate interests of the entrepreneur and the venture capitalist. MIT

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