



Doing the Deal: Negotiating and Closing A Venture Capital Financing

SIIA's Ed Tech Business Forum

The Princeton Club

New York, New York

November 28, 2006 [updated 8/24/09]

Venture Capital Pros and Cons

■ Pros

- New capital
- Capital markets experience
- Business growth experience
- Strategic value-add
- Credibility enhancement

■ Cons

- Lose management control
- Heightened operating controls and scrutiny
- Must exit
- Substantial dilution

Due Diligence

- Be prepared

- Critical issues

- Intellectual property rights / invention assignment agreements
- Capitalization
- Tax returns
- Financial statements
- Projections
- Customer relationships

Legal Documents

- Term Sheet / Letter of Intent / MOU
- Certificate of Incorporation / Designation of Terms
- Stock Purchase Agreement
- Stockholders Agreement
- Investor Rights Agreement / Registration Rights Agreement
- Stock Incentive Plan / Stock Option Plan

Term Sheet

- Purpose: to gain fundamental agreement on the principal terms of the transaction
- Issues:
 - Non-binding
 - Subject to due diligence
 - Subject to required consents and approvals
 - Need to be careful on definition of terms and carve-outs

Principles for Negotiation

- Consider the practical application
 - Who is helped; how, and how much
 - Who is hurt; how, and how much
- Allocation of potential rewards
- Allocation of potential risks
- Administrative/management burden and costs
- Flexibility to manage the business
- Flexibility to raise new capital
- Unintended consequences
- Bargaining power
- Negotiation time and cost

Certificate of Incorporation

- Purpose: to establish the terms of the security itself
- Issues:
 - Authorized capital
 - Designation of classes and series
 - Dividend and liquidation preferences
 - Super-liquidation preferences
 - Participating preferred
 - Anti-dilution terms
 - Charter-based stockholder rights

Stock Purchase Agreement

- Purpose: to organize overall transaction and provide the terms on which shares are purchased
- Issues:
 - Simultaneous sign-and-close or deferred closing
 - Closing conditions
 - Representations and warranties
 - Covenants between signing and closing
 - Indemnification

Stockholders Agreement

- Purpose: to establish the rights as between and among different stockholders of the company
- Issues:
 - Types of holders:
 - Financial, Strategic, Founders
 - Preemptive rights - exclusions
 - Transfer restrictions
 - Permitted transferees
 - ROFO / ROFR
 - Tag-Along / Drag-Along
 - Other (non-compete)
 - Board representation
 - Negative and affirmative covenants

Investor Rights Agreement

- Purpose: to establish certain ongoing rights between and among the company and key stockholders
- Issues:
 - Information Rights
 - Registration Rights (see next slide)

Registration Rights Agreement

- Purpose: to enable stockholders to force and/or participate in a public offering of shares
- Issues:
 - Demand registrations
 - Piggyback registrations
 - S-3 registrations
 - Underwriter cutbacks
 - Timing / trigger – IPO or post-IPO
 - Registrable securities
 - Number and costs

Stock Incentive Plan

- Purpose: to establish the terms of stock options or grants for employees, consultants, etc.
- Issues:
 - Restricted stock grants
 - ISOs – AMT
 - NSOs
 - Restricted stock purchases
 - FAS 123R
 - IRC 409A

Valuation - Basic Venture Capital Method

1. Estimate the value of the company at a point in the future when the investor expects liquidity (typically between 3 and 7 years)
2. Estimate the extent of future dilution to the investor's ownership interest based upon the projected future financing needs of the company
3. Calculate the percentage ownership that the investor must receive currently so that its final share of the future value of the company satisfies the investor's targeted IRR

Common discount rates (implied IRRs):

Seed financing	$\geq 80\%$
Start-up financing	50-70%
First-stage financing	40-60%
Second-stage financing	30-50%
Bridge financing	20-35%

Source: "A Method for Valuing High-risk, Long-term Investments - The 'Venture Capital Method', Daniel R. Scherlis and William A. Sahlman

Venture Capitalists Aim for 30-40% Returns

- It takes an extraordinary business to provide this level of return

Multiple of Initial Investment Required to Achieve Target Return

	4 years	6 years	8 years
30%	2.9x	4.8x	8.2x
40%	3.8x	7.5x	14.8x

The investor's targeted return directly affects the company's valuation

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