VENTURE CAPITAL FINANCING:
DOWN ROUNDS AND CRAM-DOWN FINANCINGS

SEPTEMBER 2004

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VENTURE CAPITAL FINANCING: CURRENT TERMS, DOWN-ROUNDS AND CRAM-DOWN FINANCINGS

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This outline provides a brief, practical summary of terms and conditions encountered in venture capital financings of private companies, including in so-called "down rounds" and "washout" or "cram-down" financings. Tax and accounting considerations are beyond the purview of this outline, and we urge you to consult with specialists in those areas in considering these issues. The below represents the views of the authors, and not necessarily those of Weil, Gotshal & Manges LLP. Although every effort has been made to provide accurate information in these materials, neither Weil, Gotshal & Manges LLP, nor any of its members make any warranty, expressed or implied, or assume any legal liability or responsibility for the accuracy or completeness of any information contained herein.

I. INVESTOR FAVORABLE TERMS

Beginning in mid-2000, the public equity capital markets experienced a major slowdown, sending public company valuations substantially lower. The related loss of investor confidence, uncertainty in the financial markets, and sudden sell off in entire sectors including the Internet "bubble burst," rippled through the venture capital market as

[1] The author would like to gratefully acknowledge the invaluable assistance of Peter S. Buckland a Corporate Associate at Weil, Gotshal & Manges LLP, Redwood Shores, California, in the preparation of this article.

investors weighed whether, when and how to resume investing in the turbulent market.

As a result, venture capital investors were forced to reevaluate existing portfolio companies and to determine which should survive and which should be liquidated or otherwise shut down. The surviving companies faced a distressed financing market and those not luckly enough to have substantial capital reserves were often forced to seek additional funding at lower valuations than previous rounds. The relatively few companies that were able to close flat or slightly higher valuation rounds (because of the "right" management team, business plan, market opportunity, investor interest and other ingredients for success) faced tough investment terms, protracted investor due diligence processes, and difficult choices. Investors began focusing on downside protection (not getting "burned" by a bad investment), more efficient uses of capital and an exit strategy involving a sale or merger of the company rather than an IPO.

Often lacking the funds to retain a financial advisor (or fearing a perceived stigma of "needing" a finder to raise capital and provide much-needed advice), venture capital-backed companies have increasingly relied upon experienced corporate securities counsel for advice on what are fair market terms and customary practice in the venture capital industry. A thorough working knowledge of marketplace trends can sometimes be a life-or-death matter for companies struggling for financing in today's environment.

The following are common terms that are negotiated in the context of distressed funding environments and, in particular, in down-round

venture financings. Appendix A contains samples of several of these types of provisions.

A. Valuations

Due to the absence of any public trading market for their securities, private company valuations are highly subjective. One has only to pick up an IPO prospectus to see the boilerplate "Our stock price may be subject to fluctuations" risk factor to confirm that bankers, lawyers and companies responsible for public disclosure in those deals routinely hedge against the random, unpredictable nature of newly-public company stock prices. Ultimately, the venture capital players negotiate at arm's length to determine the stock price for private companies, often based less on discounted cashflow analysis or other sophisticated financial valuation tools, than on comparable company (both public and private) or transaction valuations and the relative percentage ownership stake that an investor desires (and existing stakeholders are willing to give up) in the company or leave open for employee pools or other investors. In other words, in the absence of a firm market, valuations are determined by what a willing buyer (the investor) is willing to pay a willing seller (the company) for the pieces of the company ownership pie, each trying to strike the best deal it can.

Accordingly, investors are heavily influenced by depressed stock market prices of comparable public companies, and the potentially longer lead time before venture-backed companies can now expect to turn the corner to profitability, experience a financial market recovery, and be able to consummate an IPO, sale or other transaction in which the investors can liquidate and exit their appreciated investment. These

factors have resulted in low company valuations (relative to valuations in the late 1990s, but more like the valuations of the late 1980s and early 1990s) and greater percentage ownership stakes for investors, in order to provide higher potential returns as compensation for the greater perceived investment risk.

However, large changes in valuation for early stage companies may be less important than they appear[2]. Consider the following example. Assume a company obtains a $10 million pre-money valuation for a $5 million venture round. The hypothetical company is giving up a 33.33% ownership stake and the existing stockholders (founders and employees) will retain around 66.66% of the company after closing. Now, assume instead that the pre-money valuation was only $5 million. The same $5 million investment would give outside investors a 50.0% ownership stake, leaving the founders and employees with 50.0% ownership of the company. Even though the valuation of the company has been cut by half, the percentage ownership of existing stockholders has decreased by only 16.66%.

Companies should take into account a host of other terms now more likely to turn up in term sheets, which can seriously limit the company's flexibility in the future or prejudice the company in future venture financing rounds when subsequent investors insist on receiving the same rights.

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[2] The effect of low valuations in more mature venture-backed companies however, including possible substantial dilution for existing stockholders, the imposition of punitive provisions such as "pay-to-play" features and related employee incentive measures, are often extreme and complex. These issues are addressed in detail later in this article.

B. Enhanced Liquidation Preferences

1. High Liquidation Preferences

In making equity investments, venture capitalists have historically purchased convertible preferred stock containing liquidation preferences in the event of a liquidation, sale, merger, consolidation or other change of control of the company. In its purest form, the holder of the security receives such holder's original purchase price prior to, and in preference to, other stockholders in liquidation proceeds upon any such "liquidity event" – in other words, the holder gets its money back first before any amounts are distributed to other stockholders. If the holder would receive more from the transaction as a common stockholder than as a preferred stockholder, it would choose to convert its preferred stock into common stock and receive the greater proceeds.

However, investors in earlier stage companies in particular are currently demanding multiples of their original investment amount as a liquidation preference, almost as a "make whole" premium to protect against a low return on investment in the event the company liquidates or is sold prematurely at a low valuation (or rather to discourage or prevent such an outcome). Investors have negotiated for such multiple preferences even though they reserve a class or series stockholder voting right to veto any such liquidity event (as discussed in more detail below). The practical effect is that founders, employees and other common stockholders will not receive any liquidation proceeds unless the company is sold or liquidated for an amount greater than the aggregate liquidation preference, after taking into account the prior claims of creditors and other senior claimants.

Later stage investors encounter aggregate liquidation preferences requiring major increases in the companies' enterprise values before they can realize their preference or expected investment returns. To protect against this outcome, some new investors are increasingly seeking to obtain a preference above and beyond that of the existing preferred stockholders.

In other cases, investors negotiate for exorbitant liquidation preferences. High multiple liquidation preferences (even 5x or 6x are not unheard of), even in later stage rounds at relatively higher valuations, increase the aggregate preferred stock liquidation preferences to unrealistic exit valuations, rendering junior securities, such as common stock and stock options, worthless. In our above hypothetical, imagine if the investors had a 500% liquidation preference. In the first scenario, the investors would receive all of the liquidation proceeds if the company were liquidated (at its current $15 million valuation), and the company would need to more than double in value (to an aggregate value of $35 million) before the holders of common stock and stock options (typically the company's founders and employees) received an amount equal to or approaching the initial $10 million valuation. Now imagine if the company was engaged in its third round of financing, raising $20 million at a $50 million pre-money valuation with the a 500% senior liquidation preference. The company would have to more than double in value before the prior investors received any of the liquidation proceeds and the founders and employees would still likely not receive any liquidation proceeds. To the extent that equity incentives are important to attract or retain talent, the company would be severely handicapped by

having all its common stock and options "under water" as a result of this investor preference.

2. Participating Preferred Stock

To compound matters, many investors insist on "participating" preferred stock, alone or in combination with high liquidation preferences. Participating preferred stock entitles the holder to share in its liquidation preferences as well as the remaining liquidation proceeds pro rata with common stockholders on an as-if-converted basis. Rather than having to choose between the return on investment to preferred stockholders and that to common stockholders, the investor is entitled to both (over $28 million in our $35 million liquidation example above). Essentially, participating preferred stock allows the holder to "get his cake and eat it too," never having to convert its preferred stock into common stock in order to share in the residual upside value.

This has been justified in a number of ways, including the argument that the preferred stockholder is risking capital for the unproven venture and should be entitled to get its money back first (through a liquidation preference) before sharing shoulder-to-shoulder with other equityholders in the upside value enabled by such investor's valuable capital. Ultimately, the participating preferred stockholder is limiting its downside exposure by retaining preferential terms, while receiving the unlimited upside potential of common stockholders. The common stockholders will feel that they are bearing greater risk for the same reward, and may fear that the participating preferred stockholder will not be motivated to sell the company at anything but astronomical levels and, therefore, for a long time.

Common middle-of-the-road solutions include capping the participation amount so that there is a valuation level at which the holder will be forced to convert its shares to common stock in order to share in the potential upside value (typically 2 to 5 times the amount of its original investment), or setting a floor valuation for the liquidity event above which the class or series of preferred stock does not have a veto voting right to block the event.

C. Price Protection Provisions

Venture capital investors typically protect against dilution from subsequent issuances of equity securities by, among other things:

- retaining a special class or series stockholder voting right or restrictive covenant right to veto subsequent issuances of equity securities (as further discussed below under "Protective Provisions"),

- obtaining a contractual preemptive right to purchase enough subsequently issued securities to maintain their pro rata ownership interests in the issuer company, and

- in the case of a subsequent financing at a lower valuation (commonly referred to as a "down-round") or other dilutive issuance, receiving an adjustment to the conversion price of their preferred stock, convertible debt instrument or, sometimes, warrants or other equity derivative securities.

The latter price-based anti-dilution adjustment is usually phrased broadly to cover any issuances of equity securities at a price or for consideration less than the price paid for the protected class or series of securities. However, investors normally will agree to carve out exceptions that do not trigger an adjustment, such as:

- conversion of the protected security,
- stock-on-stock dividends and distributions,
- exercise or conversion of outstanding options, warrants or convertible securities, and
- issuances under stock option plans or equity incentive plans of a specified number of shares (typically 10 to 25% of the company's equity capital on a fully-diluted basis, depending on the developmental stage of the Company).

The company should also seek to obtain carve-outs for:

- issuances to lenders, lessors, vendors, suppliers, landlords or others doing business with the company (e.g., equity "sweeteners" given to obtain more favorable borrowing or lease terms), at least up to a certain percentage (often 2 to 5%) of the company's equity capital on a fully diluted basis, and
- issuances for mergers, acquisitions, strategic alliances, joint ventures, in-progress transactions or other situations where the business purpose and benefit are viewed as worthy of taking a conversion price adjustment out of the equation.

In many cases, the parties negotiate "pigeon-hole" exceptions, with capped amounts of dilutive securities that can be issued under certain of these exceptions. Companies and their counsel should carefully consider the nature and amount of carved-out dilutive issuances in order to preserve future flexibility for the company's maturing business. They may want to seek parallel exceptions in preemptive rights, veto privileges and other similar investor rights triggered by such dilutive issuances.

The key then becomes the pre-determined formula for adjusting the conversion price. The adjustment allows the holder to receive a greater number of shares of common stock (and thus a greater percentage ownership stake) in the company upon conversion of the protected security, the amount of which will vary depending on the type of formula. It is important to realize that, even before conversion, any such adjustment will often have the effect of shifting voting power to holders of the convertible security since they are typically entitled to vote such security on an as-if-converted basis.

We will consider three common price-based anti-dilution adjustment formulas:

1. Broad-Based Weighted Average Formula

In a weighted-average adjustment formula, the impact of the dilutive issuance is based on the relative percent that the equity sold in the dilutive financing bears to the total equity of the company, including the investors' shares. The dilutive effect is spread among the investors' original investment price and the new dilutive issuance price by weighting their relative

value in arriving at a blended conversion price. As baseball enthusiasts can appreciate, just as there are batting averages, slugging percentages, on-base averages and other endless hitting statistics, there are a number of ways to weight the relative price contributions, which depend largely on what securities are factored into the formula.

In most cases, under a "broad-based" weighted average anti-dilution adjustment formula, the conversion price is adjusted on a weighted average basis which takes into account all common stock outstanding on a fully-diluted basis after giving effect to the exercise or conversion of all outstanding warrants, options, convertible securities or other equity derivative securities. An example of such formula and its operation appears in Appendix B. Another typical formulation adjusts the conversion price based on outstanding common stock and issuances of all common stock equivalents at prices both greater or lesser than the applicable conversion price in effect at the time of the dilutive issuance, which yields the same result in effect. In either case, this type of formula dampens the magnitude of the corrective adjustment the most by spreading the dilutive effect over the most possible securities.

2. Narrow-Based Weighted Average Formula

While there are various formulations, under a "narrow-based" weighted average anti-dilution adjustment formula, the conversion price is adjusted on a weighted average basis which only takes into account currently outstanding common and preferred stock, or outstanding common stock and issuances of common stock equivalents at a price lower than the then applicable conversion price (e.g., in-the-money

options), or in extreme cases, only the protected security and the dilutive issuance itself. An example of such formula and its operation appears in Appendix B. In any such case, this type of formula provides an intermediate adjustment by spreading the dilutive effect over various prices to arrive at a blended conversion price greater than the dilutive issuance price.

3. Full Ratchet Adjustment

The strongest price protection for investors is a "full ratchet" adjustment, in which the conversion price is simply lowered to the dilutive issuance price. Since this is at the other extreme from no adjustment at all, the investor receives the most additional common stock upon conversion of the protected security. Common stockholders, optionholders and holders of other securities who do not have ratchet protection are heavily diluted by a full ratchet adjustment. In addition, a full ratchet feature of an existing preferred stock can have the effect of reducing the incentive for new investors to invest in down rounds because the resulting ratchet adjustment will increase the fully diluted percentage ownership interest, and therefore percentage voting power, of the prior investor entitled to the adjustment. Such a result may require waivers of the adjustment (if possible), renegotiation of a higher bottom limit for the ratchet adjustment, amendment of the terms of the security to accomplish such waiver or modified ratchet adjustment, or even a recapitalization of the company to make the company fundable. Counsel should be careful to consider potential changes of control, and related consequences, triggered by extreme conversion price movements.

4. Pay-to-Play Provisions

An issuer providing investors with full ratchet antidilution protection faces the dilemma that those same investors can get the benefit of the lowest price in later financing rounds as their preferred conversion price, without even providing more capital to the company. Both the company and the lead investors in a venture round may want to provide a strong incentive for co-investors to make long-term financing commitments to the company, even if they have a lesser ownership stake. Individual "angel" investors who provide small amounts of early stage capital and corporate strategic investors who bring industry expertise, customer contacts or commercial relationships to the table are typically one-time investors in the company and are usually not expected to participate in later rounds. By contrast, although not obligated to do so, traditional venture investment firms are generally expected to provide new capital in later financings of their portfolio companies.

A common method of motivating investors to provide follow-on financing is to include, in the original financing terms, a "pay-to-play" provision in which existing investors who do not participate in later rounds of financing for the issuer lose preferred stock rights or privileges, such as price-based anti-dilution protection, liquidation preferences, special or general voting rights and redemption privileges, or even the right to convert to common stock outright. This provision is usually structured as an automatic conversion upon failure to participate to the investor's full pro rata extent (such as pursuant to a preemptive right to purchase sufficient securities in the round to maintain pro rata ownership), into a "shadow" series of preferred stock resembling the original series but

lacking the eliminated right or privilege, or into common stock, as the case may be.

While a "pay-to-play" provision may be an insurance policy for a company that its investors will step up to the plate and fund the company's later rounds, these provisions can be hotly debated among different investor groups with different agendas in "split" rounds (that is, financings with multiple investors) and can be defused ultimately with special class or series voting rights to veto subsequent issuances of capital stock. In the latter case, the class or series of preferred stock burdened by the "pay-to-play" provision can assemble enough votes to condition their approval of a down round financing, for instance, upon waiver or elimination of the "pay-to-play" provision. Therefore, "pay-to-play" provisions generally work best when there is a funding-committed investor that controls the class or series of capital stock subject to the provisions.

D. Redemptions

Historically, investors typically insisted upon the right to require the company to redeem their shares 5, 6 or 7 years, for example, after the investment for their original investment amount plus a fixed percentage return (often 8-10%). This provided the investors with leverage to force some kind of exit transaction when a company had survived but had not become very successful.

However, prior to the market downturn, it had become customary in venture financing term sheets for preferred stock not to be mandatorily redeemable. One can speculate that investors perceived less risk on a case-by-case basis or could more easily achieve

portfolio-wide returns in the bull market, and were willing to trade away the minimal downside protection of pulling out their money in a redemption several years thereafter for other concessions made by companies unwilling to be saddled with the potential "time bomb" of having no funds to perform the redemption obligation after the company was faithfully sticking to the cash burn rate in its business plan. Companies further argued that redemption privileges would deter future investors by raising concerns that new financing proceeds would be used to redeem previously issued preferred stock.

In addition, there are state statutory limits on redemptions of capital stock. Section 151(b) of the Delaware General Corporation Law provides that the stock of any class or series may only be redeemed so long as immediately following such redemption, the corporation has outstanding one or more shares of stock that together have full voting powers, whether or not such share or shares are redeemable (usually not a problem). More importantly, Section 160 of the DGCL prohibits a corporation from using its funds or property to purchase its own stock when the corporation's capital is "impaired" or when the purchase would cause a "capital impairment." A corporation's capital is impaired when the corporation does not have a surplus (defined as the excess, if any, of the value of its net assets over the aggregate par value of its outstanding capital stock). If the corporation has no surplus, stock repurchase payments can be made from net profits for the fiscal year in which the payment is made and/or the preceding fiscal year (the celebrated Delaware "nimble dividend"). Also, no redemption can be made when the corporation is insolvent or would be rendered insolvent by the redemption.

California corporations have more onerous restrictions. Section 500 of the California Corporations Code, which applies both to California corporations and "quasi-California" corporations incorporated outside California, establishes two separate tests for the legality of a redemption of capital stock. Under the retained earnings test, a redemption may not be made unless the retained earnings of the corporation immediately prior thereto exceeds the amount of the proposed distribution. Under the asset-liability ratio tests, issuers must satisfy a two-part test. The first prong of the test requires that immediately after the redemption, the assets of the corporation (other than goodwill, capitalized research and development and deferred charges) would be equal to at least 1-1/4 times the liabilities of the corporation (excluding deferred taxes, deferred income and other deferred credits). The second prong of the test requires that the current assets of the corporation be at least equal to its current liabilities after making the distribution, or if the average earnings of the corporation before income taxes and interest expense of the two preceding fiscal years was less than the average interest expense of the corporation of those fiscal years, at least equal to 1-1/4 times its current liabilities. Also, no redemption can be made when the company is insolvent or would be rendered insolvent by the redemption. If these tests are not met, the company is not obliged to honor its redemption promises (see California Corporations Code 402(d)). Moreover, if redemption is made anyway, shareholders who receive the proceeds from a redemption and knew there was a violation, and directors who approve such a redemption in violation of Section 500 are liable to the corporation and its creditors for the amount of the redemption and interest

thereon. In our experience, few early-stage companies have the excess tangible net worth or working capital to meet these tests.

Notwithstanding the above company concerns and legal limits, investors now frequently request redemption privileges for a variety of reasons. Obviously, the investors can limit their losses and avoid a total write-off of their investment through early redemption. This shield is a "Catch-22" since the company may not have the money to redeem the shares by the time the investors can actually have their shares redeemed. But as an offensive tool, investors can use the threat of redemption to put pressure on the company to achieve a liquidity event within a fixed time horizon or sooner, or to grant other concessions to investors, such as warrants or board seats. Investors can also use redemptions as an orderly way to wind down a company, saving time and money in those situations where even management agrees that dissolving the company is in the best interests of all of the parties.

Theoretically, it may even turn out that redemption economically favors the company because, at the time of redemption, the redemption price is lower than the price of the company's common stock into which the preferred stock is convertible. In order to avoid being forced to hastily convert in order to avoid a redemption call in this situation, and thus losing their preferred rights, most venture investors provide that redemption is at their option, never that of the company.

Assuming the redemption is an investor "put" option (that is, the investor can cause the company to redeem the preferred stock), the parties must agree in

the charter upon at least the following principal redemption terms:

1. Timing

In the case of an investor put option, the company's best interest is served by deferring the redemption as long as possible to enable it to raise additional financing, mature and become cashflow positive, thereby reducing or eliminating the insolvency threat of being unable to perform the redemption. The principal consideration is how much time the company will need to buy in order to achieve a liquidity event (which usually retires the preferred stock by converting it into company common stock or consideration of an acquiror) or develop sufficient financial assets to defease the redemption privilege. Typically these days, early-stage companies are able to negotiate for no-put protection for four to seven years.

The investor must balance its final deadline for achieving a liquidity event against the risk that the redemption privilege backfires as described above. Once the parties agree upon the initial redemption date, they can structure the redemption in one lump sum or stagger the redemption over time in tranches (for instance, in several annual installments).

2. Redemption Price

It appears that, in the majority of deals, redemption is at the original issuance price plus any accrued and unpaid dividends, so that

the investors are getting their money back with no appreciation.[3] Note that investors actually lose the time value of the money this way, unless a fixed rate of return is factored into the redemption price or dividends are cumulative, in which case they in effect receive a coupon. Many investors rationalize this as only relevant in a downside scenario when they are reducing their stakes to cut their losses because investors would not want to put their shares back to the company if the company is doing well and they stand to profit from the investment. This provides the company with comfort that the investors will not put their shares back if the fair market value of the underlying common stock is above the original purchase price of the preferred stock. In other words, the provision becomes irrelevant if at the time of the put, the company is worth more than the post-money valuation at the time of the venture investment giving rise to the redeemable preferred stock.

On the other hand, if the redemption is a call option, investors will insist on "make whole" premiums to preserve the return on their investment against a shortened maturity, or at least premiums to the projected fair market value at the future redemption date to avoid being bought out at what turns out to be a discount. Due to the uncertainty in projecting future value, few venture investors

[3] This may be due in part to Internal Revenue Code Section 305, which theoretically treats redemption premiums as constructive distributions of the preferred security over the pre-redemption term, resulting in taxable "phantom" income to the holder equal to the fair market value of the deemed distributions.

in our experience are willing to grant call options.

3. Eligibility

Companies granting a put redemption privilege often want to reserve the privilege only for major investors who hold either a minimum number of shares of the preferred stock or a minimum percentage ownership of the entire company. Sometimes, companies even grant contractual repurchase rights to a select few investors instead of incorporating the redemption privilege into their charter as a class or series privilege. Most companies also try to require each holder to make redemption elections, so that large investors cannot elect on behalf of the entire class or series.

E. Protective Provisions

Venture investors typically obtain special class or series voting rights requiring their approval as preferred stockholders before the company undertakes certain actions. These actions commonly include:

- Amending the charter or bylaws to adversely affect the rights, privileges and preferences of the preferred stock,

- Declaring or making dividends or distributions on common stock or junior securities,

- Repurchasing or redeeming common stock or junior securities,

- Changing the size or composition of the board, especially where the venture investors have board representation rights,

- Issuing securities on parity with, or senior to, the preferred stock,

- Issuing common stock or junior securities at dilutive prices or other than pursuant to employee pools, mergers, acquisitions, joint ventures, financing or leasing arrangements or other "buckets" approved by the board or within agreed upon size limits,

- A merger, consolidation or sale of the company, and

- A voluntary liquidation, dissolution, recapitalization or winding up of the company.

These actions would change the venture financing deal post-closing, directly dilute the preferred stock or constitute extraordinary transactions. Used this way, the veto privilege is thus an obvious protection against actions which undermine the investment.

However, more recently, investors have exerted greater control over portfolio company affairs by adding additional actions for their approval, many of which have traditionally required board approval (in some cases, with the consent of the investors' representatives on the board) such as:

- Change in nature or line of business,

- Incurring debt above fixed dollar amounts or debt/equity ratios,

- Making capital expenditures or entering into contracts obligating the company to spend more than fixed dollar amounts,

- Increasing option pools or permitting accelerated option vesting,

- Acquisitions of other companies, licenses of a material portion of the company's assets or other transactions outside the ordinary course of business,

- Approval of the annual budget and changes in the budget above a specified dollar amount,

- Changes in executive management, and

- Creation of subsidiaries.

Companies complain that these consent requirements burden the company and limit its flexibility in operating its business, and are unnecessary especially where the investors have board representation and, therefore, the ability to influence decisions on these items. They try to require preferred stockholders to vote together as a class, in order to avoid having to obtain the consent of each series of preferred stock separately, and they argue for simple majority votes instead of super-majority voting thresholds. In any event, companies often resist giving any particular investor or group of investors a blocking right simply because they own enough shares to form a voting block large enough to control the class or series of preferred stock having the protective provision.

Investors reply that they merely want the company to run these extraordinary items by the investors, who will naturally comply if it is in everyone's best interest. Their board representation is a minority of the board and, thus, the investors really have no final say in corporate governance otherwise. Each series has its own concerns, having come in at different valuations with different liquidation preferences. In particular, matters such as amending the charter or bylaws to adversely affect the preferred stock, should be a matter of self-determination for each series, rather than losing control over the destiny of one's own series. Particular investors apply that logic to their own stake and insist on super-majority voting requirements that effectively give them a blocking position.

And so, back and forth the debate goes. Often lost in all this is the impact of voting rights of common stockholders, which as a class must approve the terms of the preferred stock, including the foregoing protective provisions, unless the charter provides for "blank check" preferred stock to be designated by the board and the investors have permitted the company to set aside shares for issuance in this manner (which many venture investors do not permit). We frequently find that the founders of the company, who are no longer part of the executive management team of the company after several rounds of venture financing or who may have departed the company after it got off the ground, are large or majority common stockholders. Accordingly, founders can hold out on approval of restrictive protective provisions or other harsh terms at the very moment the company is struggling to put together financing, and play "chicken" with the investors seeking these terms. Founders may be unhappy with

the dilution from successive financings (after all, they once owned the whole company) or the direction of the company. As a result, founders may complicate the deal by making it a three-way negotiation, and withhold their approval until they receive cheap warrants, board representation or other concessions. Practitioners should consider the rights and powers of each corporate constituency in early planning stages of any financing.

F. Staggered Financings

Venture capital investors have long committed more than their initial funding amount to portfolio companies to cover financing needs through the life cycle of the companies prior to their liquidity events (typically IPOs or sales of the companies in which the investors can exit their investments). The process can be analogized to a bank financing construction of a building, in which the bank lends portions of the total amount of money needed to complete the project in installments only after the foundation is set, the building is framed, wiring and pipes are installed, and each other construction phase is completed. In the past, the construction loan analogy has been distinguishable because venture investors would invest in different rounds at different (typically higher) valuations, reflecting the growth and increasing maturity of the company.

However, in recent years there has been a noticeable increase in "staggered" financings at the same valuation, whereby the total investment amount for a single financing round is split up into tranches that are funded in stages only after agreed upon milestones are satisfied. These milestones are often based on business plan projections or promises made

to investors during due diligence, thereby forcing the company to live by its forecasts or future plans in exchange for the full funding to occur.

Structuring the staggered financing commitment raises a variety of issues, aside from the straightforward business deal. The company will want milestones that are clearly drafted and within its control to the greatest extent practicable. Given the difficulties that investors are facing, the company should request that transaction documents specify the consequences to investors that fail to make their milestone payments in a timely fashion. Investor board or stockholder voting control, restrictive operating covenants or similar terms in the venture financing documents, however, may frustrate satisfaction of the milestones. In addition, there is a substantial risk that if valuations fall substantially, the investor will claim that any given milestone has not been met, leaving the company with only legal recourse, which practically speaking, is too expensive and time consuming to be a viable alternative for a young company with no funds. The company may also argue that it should not resatisfy the initial closing conditions at consummation of each tranche, on the theory that but for satisfaction of the milestones, the investors would have funded the entire investment amount in the first closing.

On the other hand, investors often want milestones to be flexible enough to adapt to changing market or company conditions, which can create a "moving target" problem for the company. Investors may want reassurance at each closing that there are no legal prohibitions on further funding, company counsel will opine to the same legal matters upon

which the investors funded in the first place, and other conditions for initial funding are still satisfied.

II. DOWN ROUNDS AND "WASHOUT" AND CRAM-DOWN FINANCINGS

A. Down Rounds

Current market conditions, coupled with the reality that private company valuation is an art, not a science, and more the product of arms-length negotiation, have dramatically decreased valuations of venture-backed companies in recent years. Like public investors, venture investors are again focused on profitability, sound business plans and proven management teams, and are spending more time due diligencing fewer investments made at much lower valuations.

Many venture funds continue to concentrate on cleaning up their portfolios and funding existing portfolio companies that need to stay afloat. Companies have and continue to implement deep cost-cutting measures and layoffs, and exit non-core business lines, to keep their burn rates at attractively low levels for investors.

As a result, many companies are being forced to raise funds in "down rounds" – so called because the equity securities are sold at valuations lower than for prior financings. These down rounds raise a number of issues.

1. Dilution

Existing investors and stockholders experience immediate and frequently substantial dilution from

down rounds. This is due to the fact that their ownership interests, together with employee pools of outstanding options, are compressed into the lower valuation. Indeed, the pre-money valuation in a down round is not only lower than the post-money valuation for the previous financing round, it does not even leave extra valuation room for options and other securities issued in the intervening period between the financing rounds. Therefore, a common stockholder will own proportionately less of the company than such holder did immediately prior to the down round, and such holder's shares will be worth less.

To illustrate, consider our original hypothetical case of a $5 million initial venture financing round at a $10 million pre-money valuation. If the price per share was $1.00, then the investor would purchase 5,000,000 shares worth $5 million and receive an approximate 33.33% ownership stake. Now imagine that the company needs to raise another $5 million in a follow-on financing round at a $5 million pre-money valuation. Even assuming no issuances of capital stock in the interim, the new investors would pay around $0.33 per share to buy approximately 15,000,000 shares of the new series of preferred stock, representing a 50% ownership stake in the company. The first round investor, assuming no anti-dilution adjustment to its investment, would be left with stock worth approximately $1,666,667 (a $3,333,333 write-down from the $5 million investment, or a two-third loss on the investment) and representing a 16.66% ownership stake in the company (nearly 35% less than before the down round, wiping out nearly two-thirds of the investor's preexisting voting power). If the company has granted options or warrants or issued stock in the interim, the first round investor is left with even less.

2. Anti-Dilution Protection

As discussed above in "Price Protection Provisions," the prior venture investors can protect against the dilutive effect of a down round by obtaining weighted average or full ratchet adjustments to their preferred stock conversion price. Exercising preemptive rights to participate in the down round will not avoid the dilution of previously purchased securities (and may turn out eventually to be "good money chasing bad money"), but price protection provisions can prevent or minimize such dilution by giving the holders additional stock underlying those securities – commonly referred to as "repricing" the prior round (a misnomer because only the conversion price is reset).

Depending on the type and amount of adjustment, holders of common stock, options, warrants or other junior securities are diluted more than they otherwise would be by the down round. Their securities receive no adjustment while the preferred stockholder with price protection does. Therefore, the value of their securities as a component of the company's overall capitalization is decreased into a shrinking sliver of the pre-money valuation for the down round, and the preferred stockholder's conversion price adjustment further dilutes the percentage ownership of the common stockholders and optionholders, who are typically the founders, managers and employees of the company. This can make it difficult to obtain their stockholder approval for the financing (if needed) without readjusting the conversion price upwards, and make it difficult to attract and retain employees unless "top-up" option

grants, "in-the-money" option arrangements, cash bonuses or other concessions are made.

In a down round, it is critical for the company to calculate the anti-dilution adjustments to existing series of preferred stock as it considers the terms of the new financing, keeping in mind that the lower the price of the new round, the larger the percentage of the company that will be owned by the existing preferred investors in relation to all other current stockholders after the financing.

3. More Favorable Terms

If investors take a hard line on valuations, they are also more likely to drive a hard bargain on non-price terms. Indeed, if the lower price reflects the added risk of the venture, they will tend to protect against that risk more aggressively by insisting on staggered funding, high liquidation preferences, senior liquidation preferences, participating preferred, cumulative dividends, even stronger price protection provisions than prior investors, mandatory redemption clauses, increased board control, broad protective voting rights, senior registration rights, senior co-sale or tag-along rights to sell out alongside others, take-along rights to require other securityholders to sell out in deals they strike with third parties, and a whole host of other restrictive terms. Many of these are discussed in detail above. Left with no other financing alternatives and facing insolvency, the company may have no choice but to accede to these demands.

4. Under Water Securities

The terms sought by down round investors often force the investors to compromise, or the

company to make third party concessions, because they impact other securityholders or employees whose cooperation in the investment and the venture are needed. As discussed above, heavy dilution of existing common stockholders and junior preferred investors (exacerbated by the anti-dilution adjustments for previous venture investors) can make it difficult to obtain their approval, as stockholders, of the proposed transaction, or cause a significant employee retention problem, unless the valuation or anti-dilution adjustments are revisited, the company adjusts ownership with additional option or warrant grants, or the company and the investors make other concessions to those constituencies.

Similarly, if the new investors demand a high liquidation preference or participating preferred stock, the preexisting securities may be essentially worthless. Consider our hypothetical down round financing in which the new investors are willing to invest another $5 million at the lower $5 million pre-money valuation. If the terms for the new series of preferred stock include a 500% liquidation preference, then the other securityholders would receive nothing if the company were liquidated or sold at any valuation less than $25 million. Optionholders may not only have exercise prices greater than the new down round price, but existing preferred stockholders would actually be exposed to a greater potential loss (in our example, a total loss) than their investment write-down.

This term alone often leads preexisting securityholders to the bargaining table for fear of being disenfranchised. Their leverage usually rests in class or series voting rights on the financing (for instance, under state corporate laws or the terms of prior venture rounds) or their indispensability as

founders, managers or key employees of the company. As further discussed below, the company may even wind up being recapitalized in order to accommodate all these constituencies. As a compromise, the liquidation preference sought by investors may be moderated or junior securityholders may be given special voting rights or other protections against the company liquidating without leaving any residual value for them.

5. Corporate Changes

It should come as no surprise that down rounds are often accompanied by belt-tightening and corporate governance measures. In particular, venture investors are requiring companies to cut costs, engage in layoffs and furloughs, and otherwise reduce their burn rates before investing. Investors are also conditioning investments on management changes, changes in business plans, and other fundamental changes to companies. The lower valuation upon which investors invest, anti-dilution adjustments, changes in board composition and other contractual provisions can give down round investors board or securityholder voting control of the company, allowing them to implement these steps even after closing.

Down round investors are typically highly motivated to stay actively involved in the company in order to monitor and manage their investment, and are more likely than most investors to exercise corporate governance control over the company. Like mergers and acquisitions in which companies must plan their post-closing integration, down rounds are more likely to succeed in the long run (and less likely to blow up after closing) if "social issues" surrounding corporate

governance and future operating plans are resolved beforehand so that the parties can set their expectations properly. Some social issues arising from down rounds—such as marketplace and customer perception of the company, employee reaction to the news that the company is declining in value, management distraction by the financing process, and upheaval among company constituencies from onerous financing terms—may never be resolved, and are simply costs of doing the deal.

B. "Washout" and Cram-Down Financings

In a number of deals, companies desperate for financing in order to survive are accepting venture financing at drastically reduced valuations, leading to dramatic dilution of existing securityholders. The pre-money valuations are so low that preexisting stock and options are virtually worthless. With no other alternative for the company to remain viable, holders of preexisting securities are forced to accept these cram-down terms as their only hope for eventually realizing any value upon their securities.

In order to create some residual value for employees holding under-water options, clean up their capital structure, or shed their past corporate finance history, some companies have engaged in recapitalizations designed to provide a "fresh restart" for the companies. In such scenarios, outstanding preferred stock is converted to common stock so that the preferred stockholders share pari passu with holders of common stock and options, frequently the founders, management and employees of the company who would otherwise have little equity incentive to make the company succeed or approve the transaction, for that matter. Alternatively, existing preferred

stockholders may waive anti-dilution adjustments arising from the down round, or the company and new investors may agree upon "top-up" option grants or other employee benefits and incentives as part of the transaction.

Even though these "washout" financings and recapitalizations may rescue a company on the brink of collapse, they can expose the directors, management and majority stockholders of the company to liability for breach of fiduciary duty, and potentially lead to rescission of the transaction. If the company turns out to be successful later on, non-participants in the washout round who lost out on the subsequent equity appreciation may accuse the company and its directors of conflicts of interest, lack of due care in undertaking the transaction, failure to disclose the company's prospects or other information material to their investment decision in voting upon or deciding whether to invest in the transaction, or other improprieties.

These issues were on public display in the seminal case of Michael Kalashian et al. v. Advent VI Limited Partnership et al. ("*Alantec*")[4], involving Alantec Corp., a Silicon Valley-based manufacturer of computer networking equipment. In a nutshell, the founders of Alantec saw their ownership stake in the company drop from 8% to less than 0.007% as a result of a series of financings in 1990-1991 after the founders had left the company. In early 1996, Alantec was acquired by Fore Systems Inc. for approximately $820 million. The founders sued the company, its board, and several venture capital fund investors in the

[4] Michael Kalashian et al. v. Advent VI Limited Partnership et al., Case No. CV-739278 (Sup. Ct. Santa Clara Co., filed March 23, 1994).

company for fraud, breach of fiduciary duty, and vicarious liability based on conspiracy. They claimed, among other things, that venture capitalists sitting on the board of Alantec, believing that the founders had too much stock in the company in view of their diminished roles in the company, conspired to deliberately dilute the founders by issuing themselves additional stock below the true fair market value of the company, while giving away common stock to the new management of the company simply to permit them to vote those shares in favor of the new financings. Among other things, the defendants countered that, at the time of the financings, Alantec was on the verge of bankruptcy, was unable to line up any other financing sources, and had to issue the stock to new management in order to retain and motivate them to run the company. While the case settled out of court, the plaintiffs successfully withstood motions for summary judgment.

Two recent Delaware cases further illustrate the problems and potential pitfalls of cram-down financings, in particular where the investors and the company impose "pay-to-play" provisions or recapitalizations with similar objectives. In Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp. et. al. and Canadian Imperial Bank of Commerce ("*Juniper Financial*")[5], Benchmark Capital Partners ("Benchmark") sued its financially distressed portfolio company, Juniper Financial Corp., a number of directors of Juniper, and Canadian Imperial Bank of Commerce ("CIBC"), a later stage investor in Juniper, for their respective roles in a

[5] Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp. et. al. and Canadian Imperial Bank of Commerce., C.A. No. 19719 (Court of Chancery of the State of Delaware, July 15, 2002), *aff'd*, No 680-2002 (Supreme Court of the State of Delaware, April 16, 2003).

"wash-out" financing of Juniper. Like *Alantec*, the *Juniper Financial* case raises allegations of breach of fiduciary duties by controlling stockholder investors and questions the ability of companies to pursue these financings at the expense of previous investors. In addition, Benchmark argued that the company was obligated under its charter not to take any action that would impair the protective privileges and anti-dilution rights held by Benchmark as a holder of the company's preferred stock. The motion for injunctive relief requested in the case by Benchmark, to prevent the recapitalization, was denied by the Court of Chancery on relatively narrow technical grounds instead of the core fiduciary duty issues at the heart of the case,[6] and the judge presiding over the motion appeared to signal strong hesitation to interfere in what the Court considered a commercial transaction between sophisticated parties.[7]

In another case between two prominent venture capital firms, Weiss, Peck and Greer, LLC ("WPG") brought suit against Hummer Winblad Venture Partners ("Hummer") its individual partners, questioning the validity and implementation of a pay-

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[6] Among other things, the Court refused to invalidate the merger used by the company to overcome the charter's anti-impairment clause and authorize the new dilutive series of preferred stock, since the charter's protective provisions cited by Benchmark did not expressly prohibit mergers to accomplish such charter amendments. *Id.* at 291.

[7] In balancing the equities, the Court stated: "While loss of a shareholder's right to vote would certainly be a factor that must be given serious weight in this analysis, when viewed in light of the factual setting of this case, I am of the opinion that Benchmark's risks are minor when compared to those which would likely result from depriving Juniper of financing through the Series D Transaction. Considering that Benchmark would recover nothing (or almost nothing) if Juniper were forced into liquidation, my conclusion that the equities tip in favor of Juniper is bolstered even more." *Id*. at 44.

to-play provision in a financing of Quiver, Inc. In, Weiss, Peck and Greer, LLC et. al. v. Hummer Winblad Venture Partners et. al. ("*Quiver*")[8], WPG alleges that Hummer, as a controlling shareholder in Quiver, Inc. and one of the individual partners of Hummer, as a member of the board of directors of Quiver, Inc., breached fiduciary duties owed to WPG and gave itself a "sweetheart deal" by approving and implementing a "cram-down" financing that punished prior investors unwilling or unable to further fund the company. Hummer denied the claims of breach of fiduciary duty along the lines of the defenses presented in *Alantec*. Pending further adjudication, *Quiver* raises serious concerns about the validity of "pay-to-play" provisions, when and how they can be implemented and the meaning of "interested" directors in venture capital backed companies. If nothing else, the fact that some venture capital firms have been willing to bring lawsuits to mitigate what in the past was perceived as investment risk, could have a chilling effect on the ability of companies to raise follow-on venture financing in distressed situations.

The *Alantec, Quiver* and *Juniper Financial* litigations have been wake-up calls to the venture capital community. Companies, investors and their counsel should be sensitive to common issues and tactics for addressing such issues in heavily dilutive financing transactions. In order to defend against collateral attack, the company and its board need to build a strong record that the transaction was carefully considered on a fully informed basis by the board, was the best strategic alternative available to the company,

[8] Weiss, Peck and Greer, LLC et. al. v. Hummer Winblad Venture Partners et. al., C.A. No. 19893-NC (Court of Chancery of the State of Delaware).

was approved by securityholders of the company (if at all) only after full disclosure of all material information, and was completely above-board in all material respects. There are a number of tools available to build this record, depending on the situation at hand:

1. Market Checks

The company and its board should conduct thorough, ongoing market checks to determine whether the washout financing terms are the best value reasonably attainable in the marketplace. In management buyout situations, courts have placed great emphasis on whether companies set up appropriate processes for conducting market checks, as evidenced by board minutes and other such documentation as described below, rather than simply selling out to insiders without an auction or efforts to seek competitive bids. Ideally, companies contemplating dilutive financings should solicit interest from as many credible financing sources as practicable, to provide support for the valuation and terms and to counter claims that the board failed to act in good faith, prudently or on an informed basis.

In this regard, counsel should be careful to avoid exclusivity provisions in a term sheet. Either the company should refrain from executing a term sheet or entering into other binding arrangements that limit its flexibility until a thorough market check can be conducted, or the company should limit the scope of any exclusivity to maintaining the confidentiality of that particular proposal (i.e., the company will not shop that term sheet, but can continue to solicit interest from others). Otherwise, the company could

be accused of handcuffing itself before it can take this and other steps to minimize its liability exposure.

2. Explore Alternatives to Financing

The company and its board should fully explore all alternatives to financing, including a sale of the company or liquidation. If the company is nearly bankrupt, it may very well be the case that there are no buyers so a sale is not feasible, and liquidation will not even satisfy creditors, much less return any value to stockholders. However, wherever possible, the company should avoid limiting its options to heavily dilutive financings, if it can be sold at a higher valuation or resort to other avenues of maximizing stockholder value.

3. Financial Advisor or Appraisal

If the company has the financial resources to do so, it should consider engaging an investment banking firm or other securities institution to assist in fundraising, conduct orderly market checks, explore strategic alternatives, assess the industry and competitive landscape, advise on valuation and terms, provide a fairness opinion to support the board's determination, or render an appraisal of the company's stock to support the down round valuation. Sometimes the outsourced expertise alone is more valuable than the valuation services, in which even the appropriate basis for valuation (e.g., going concern, comparable transaction or companies, liquidation analysis, discounted cashflow analysis) is often open to debate.

4. Disinterested New Investors

In exploring all available alternatives, the company should bring in a new investor to lead the round and negotiate the price if possible. A company engaging in a washout round led by existing investors and insiders may appear to lack the objectivity of a new investor leading the round. Even if existing investors participate in the round with the new lead investor, the new lead investor will re-negotiate the valuation with the company based on the investor's own fresh due diligence process, and help establish that the price and terms were negotiated on an arms-length basis. The company and its preexisting investors normally will be motivated to bargain for the highest possible valuation and best terms since they (i) will be diluted by the new investor, often to an extent unsalvageable by price-based anti-dilution provisions even if they are full ratchet adjustments, and (ii) may be made to stand in line behind the new lead investor in exercising valuable rights such as liquidation preferences and registration rights. If the new lead investor imposes some of the investor-favorable terms discussed above, or insists on control of the new series of stock, the board will at least have a clear record that the new lead investors, and not the directors or existing investors, imposed such terms on the company.

5. Special Committees

The company may want to establish a special committee of the board of directors to handle the transaction, especially if the board has venture capitalists who will invest in the financing or are otherwise interested in the transaction. The special committee should conduct market checks, explore strategic alternatives, negotiate the transaction, and make recommendations to the full board. Ideally, the

special committee would consist of disinterested directors, as well as representatives of diluted classes or series of capital stock (e.g., prior preferred stockholders and common stockholders) who could look out for their special interests. In *Alantec,* members of the board who clearly represented the interests of the common shareholders approved an early, though heavily dilutive, financing round, thereby providing an affirmative defense for the defendants.

Unfortunately, it is often difficult to identify truly disinterested directors. Many directors of venture-backed companies have conflicts of interest because they are members of management or represent venture investors that stand to lose or gain in the deal, they hold options in the company that will be directly affected by the deal, or they will receive "refresher" option grants in the deal to gross them up for the dilution they will experience. Since existing preferred stockholders having anti-dilution protection will be diluted to a lesser extent, and common stockholders and optionholders will be disproportionately affected as a result, even existing stockholders are not similarly situated and can differ in their view of a transaction, depending on who is washed out. Even if one can identify a few truly disinterested directors, many directors are uncomfortable serving on the boards of troubled companies, much less being primarily responsible for "hail Mary" transactions, due to the very same liability concerns they could help insulate the company from. If the company is unable to assemble a special committee, it should at least limit the role of interested directors in the process to the greatest extent possible.

6. Stockholder Approval

Companies may want to consider obtaining stockholder approval of the transaction, especially if the board has conflicts of interest, if the interests of the common stockholders or other junior securityholders are not represented on the board, or if the board wishes to build a stronger record by having stockholders bless the transaction. Counsel should note that the consent solicitation or formal stockholder meeting process, coupled with preparation and circulation of information statements or other proxy/consent solicitation materials (which in turn may need to be filed and reviewed by state blue sky authorities as solicitation materials), will most likely delay closing precisely at the time when the company is desperate for financing to continue operations. Also, there is a potential risk that the transaction may be rejected by stockholders once they realize that the transaction will wash them out.

However, the approval process can be accomplished as part of a rights offering to stockholders allowing them to participate in the financing as an investor (see discussion below), and approval by common stockholders can provide a strong affirmative defense for the transaction. In fact, merely notifying stockholders in advance of the transaction, while not estopping them from complaining later, may elicit any grass roots support or opposition and serve as a litmus test for common stockholder sentiment toward the transaction. Notice of the transaction without contemporaneous opposition may also serve as evidence that stockholders in fact were not interested in participating in the round and supporting the company at its time of need, and instead regretted passing on

the opportunity only when it became apparent they missed out on a big windfall.

7. Rights Offering

The company should always consider offering the new stock, on the same terms as all other investors, to existing securityholders of the company, even if they do not enjoy preemptive rights. The offer to participate in the new financing round on the same terms provides a means for existing securityholders to protect themselves against dilution, and can help support a record of good faith and fair and equal treatment of all securityholders of the company. Indeed, the *Alantec* plaintiffs argued that the defendant directors' fiduciary duties required them to open up the dilutive financing rounds to all other shareholders.

A rights offering, however, can be expensive and time consuming, and may not completely cleanse the transaction since other investors, especially founders and employees holding common stock, may not have the financial resources to participate in a new round of financing on the same terms as a financial investor with deep pockets. Also, the company may have many non-accredited or unsophisticated securityholders (for instance, low-level employees who have exercised options) who must be excluded from the offering in order to preserve a private placement exemption from registration under the Securities Act of 1933, as amended, or to comply with state blue sky requirements. The company may even simply be unable to reach securityholders and notify them of the transaction or rights offering (e.g., departed employees).

Typically, in a rights offering, the company gives other securityholders the right to participate on a pro rata basis in the dilutive financing, and delivers an information statement or other documents detailing the transaction and the rights offering. Practitioners should be aware that state blue sky laws may require filing and review of solicitation materials in the absence of federal securities law preemption. There are no standard forms or requirements for these disclosure documents, and practice varies widely from registration statement disclosure levels to relatively short correspondence warning of the company's dire situation and extreme dilution faced by non-participating stockholders. However, the disclosure documents can create independent liability to stockholders if they contain material misstatements or omissions.

8. Improved Terms

The company can support its claim that the transaction was bargained in good faith at arms-length by seeking pro-company terms. For instance, the company can lower liquidation preferences, eliminate participating preferred features, add pay-to-play provisions, water down protective veto provisions, increase its employee pool on a post-money basis, or otherwise improve upon the terms in its last round of financing. Or the company can seek future performance-based milestones which, if achieved, reprice the down round, trigger upward adjustments in the conversion price of the dilutive security, or lead to improved terms for the company.

9. Written Record

Counsel needs to document the financing and corporate approval process carefully and diligently. Board minutes should contain a clear record of the market checks, outside financial advice, evaluation of strategic alternatives, special committees and other measures to neutralize self-dealing and conflicts of interest, efforts to protect diluted equity stakeholders, and other steps taken in the process of completing the financing. Plaintiffs will closely scrutinize the board's deliberative process to determine if, and courts will be more inclined to uphold a transaction if it appears that, the board fully explored all other alternatives, acted in good faith and in the best interests of the company, as opposed to self-interest, and only disproportionately diluted other securityholders as a last resort in order to get the best deal reasonably possible under the circumstances.

APPENDIX A

SAMPLE PROVISIONS FOR VENTURE CAPITAL FINANCING TRANSACTIONS

LIQUIDATION PREFERENCE

In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

[Version 1 - (Non-Participating Preferred Stock]

Payments to Holders of Preferred Stock. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, the holders of shares of Preferred Stock then outstanding shall be entitled to be paid out of the assets available for distribution to its stockholders before any payment shall be made to the holders of Common Stock by reason of their ownership thereof, an amount equal to the greater of (i) [__ times] the applicable Original Issue Price of the Preferred Stock, plus any dividends declared but unpaid thereon, or (ii) such amount per share as would have been payable had each such share been converted into Common Stock pursuant to Section [___] immediately prior to such liquidation, dissolution or winding up (the amount payable pursuant to this sentence is hereinafter referred to as the "Preferred Stock Liquidation Amount"). If upon any such liquidation, dissolution or winding up of the Corporation the remaining assets available for distribution to its stockholders shall be insufficient to pay the holders of shares of Preferred Stock the full aforesaid preferential amount to which they shall be entitled, the holders of shares of Preferred Stock shall share ratably in any distribution of the remaining assets available for distribution in proportion to the respective amounts which would otherwise be payable in respect of the

shares held by them upon such distribution if all amounts payable on or with respect to such shares were paid in full.

Payments to Holders of Common Stock. After the payment of all preferential amounts required to be paid to the holders of Preferred Stock, the holders of shares of Common Stock then outstanding shall be entitled to receive the remaining assets of the Corporation available for distribution to its stockholders as otherwise set forth in this Certificate of Incorporation.

A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "Deemed Liquidation Event"), thereby triggering payment of the liquidation preferences described above [unless the holders of [___]% of the Preferred Stock elect otherwise].

[Version 2 - Fully Participating Preferred Stock]

Preferential Payments to Holders of Preferred Stock. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, the holders of shares of Preferred Stock then outstanding shall be entitled to be paid out of the assets available for distribution to its stockholders, before any payment shall be made to the holders of Common Stock by reason of their ownership thereof, an amount equal to the applicable Original Issue Price of the Preferred Stock, plus any dividends declared but unpaid thereon. If upon any such liquidation, dissolution or winding up of the Corporation the remaining assets available for distribution to its stockholders shall be insufficient to pay the holders of shares of Preferred Stock the full amount to which they shall be entitled, the holders of shares of Preferred Stock

shall share ratably in any distribution of the remaining assets available for distribution in proportion to the respective amounts which would otherwise be payable in respect of the shares held by them upon such distribution if all amounts payable on or with respect to such shares were paid in full.

Distribution of Remaining Assets. After the payment of all preferential amounts required to be paid to the holders of shares of Preferred Stock, the remaining assets available for distribution to the Corporation's stockholders shall be distributed among the holders of the shares of Preferred Stock and Common Stock, pro rata based on the number of shares held by each such holder, treating for this purpose all such securities as if they had been converted to Common Stock pursuant to the terms of the Certificate of Incorporation immediately prior to such dissolution, liquidation or winding up of the Corporation. The aggregate amount which a holder of a share of Preferred Stock is entitled to receive under this Section [_____] is hereinafter referred to as the "Preferred Stock Liquidation Amount."

A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "Deemed Liquidation Event"), thereby triggering payment of the liquidation preferences described above [unless the holders of [___]% of the Preferred Stock elect otherwise].

[Version 3 - Cap on Preferred Stock Participation Rights]

Preferential Payments to Holders of Preferred Stock. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, the holders of

shares of Preferred Stock then outstanding shall be entitled to be paid out of the assets available for distribution to its stockholders, before any payment shall be made to the holders of Common Stock by reason of their ownership thereof, an amount equal to the applicable Original Issue Price of the Preferred Stock, plus any dividends declared but unpaid thereon. If upon any such liquidation, dissolution or winding up of the Corporation the remaining assets available for distribution to its stockholders shall be insufficient to pay the holders of shares of Preferred Stock the full amount to which they shall be entitled, the holders of shares of Preferred Stock shall share ratably in any distribution of the remaining assets available for distribution in proportion to the respective amounts which would otherwise be payable in respect of the shares held by them upon such distribution if all amounts payable on or with respect to such shares were paid in full.

Distribution of Remaining Assets. After the payment of all preferential amounts required to be paid to the holders of shares of Preferred Stock, the remaining assets available for distribution to the Corporation's stockholders shall be distributed among the holders of the shares of Preferred Stock and Common Stock, pro rata based on the number of shares held by each such holder, treating for this purpose all such securities as if they had been converted to Common Stock pursuant to the terms of the Certificate of Incorporation immediately prior to such dissolution, liquidation or winding up of the Corporation. The aggregate amount which a holder of a share of Preferred Stock is entitled to receive under this Section [____] is hereinafter referred to as the "Preferred Stock Liquidation Amount;" provided, however, that if the aggregate amount which the holders of Preferred Stock are entitled to receive under this Section [___] shall exceed [$_____] per share (subject to appropriate adjustment in the event of a stock split, stock dividend, combination, reclassification, or similar event affecting the Preferred Stock) (the "Maximum Participation Amount"), each holder of

Preferred Stock shall be entitled to receive upon such dissolution, liquidation or winding up of the Corporation the greater of (i) the Maximum Participation Amount and (ii) the amount such holder would have received if such holder had converted his, her or its shares of Preferred Stock into Common Stock immediately prior to such dissolution, liquidation or winding up of the Corporation (the greater of which is hereinafter referred to as the "Preferred Stock Liquidation Amount")."

A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "Deemed Liquidation Event"), thereby triggering payment of the liquidation preferences described above [unless the holders of [___]% of the Preferred Stock elect otherwise].

REDEMPTION

[Version 1 - Mandatory Redemption as of a certain date]

Subject to the rights of Preferred Stock which may from time to time come into existence, this corporation shall redeem, from any source of funds legally available therefor, the Preferred Stock [in _____ [quarterly] [annual] installments beginning on _____, and continuing thereafter on each _____, _____, _____ and _____ (each a "Redemption Date") until _____, whereupon the remaining Preferred Stock outstanding shall be redeemed]. The corporation shall effect such redemptions on the applicable Redemption Dates by paying in cash in exchange for the shares of Preferred Stock to be redeemed a sum equal to $_____ per share of Preferred Stock (as adjusted for any stock dividends, combinations or splits with respect to such shares) plus all declared or accumulated but unpaid dividends on such shares (the "Redemption Price"). The number of shares of Preferred Stock that the corporation shall be required under this paragraph to redeem on any particular Redemption Date shall be equal to the amount determined by dividing (i) the aggregate number of shares of Preferred Stock outstanding immediately prior to the Redemption Date by (ii) the number of remaining Redemption Dates (including the Redemption Date to which such calculation applies). Any redemption effected pursuant to this paragraph shall be made on a pro rata basis among the holders of the Preferred Stock in proportion to the number of shares of Preferred Stock then held by such holders.

[Version 2 - Redemption at Option of Majority of Holders of Preferred Stock]

Subject to the rights of Preferred Stock which may from time to time come into existence, at any time after

_____, but within thirty (30) days (the "Redemption Date") after the receipt by this corporation of a written request from the holders of not less than a **[**_____%**]** majority of the then outstanding Preferred Stock that all or some of such holders' shares be redeemed, and concurrently with surrender by such holders of the certificates representing such shares, this corporation shall, to the extent it may lawfully do so, redeem the shares specified in such request by paying in cash therefor a sum per share equal to $_____ per share of Preferred Stock (as adjusted for any stock dividends, combinations or splits with respect to such shares) plus all declared or accumulated but unpaid dividends on such shares (the "Redemption Price"). Any redemption effected pursuant to this paragraph shall be made on a pro rata basis among the holders of the Preferred Stock in proportion to the number of shares of Preferred Stock then held by such holders.

[Version 3 - Redemption at Option of Individual Shareholder]

Subject to the rights of Preferred Stock which may from time to time come into existence, at the individual option of each holder of shares of Preferred Stock, this corporation shall redeem, on _____ of each year commencing with ____ and continuing thereafter (each a "Redemption Date"), the number of shares of Preferred Stock held by such holder that is specified in a request for redemption delivered to this corporation by the holder on or prior to the _____ immediately preceding the applicable Redemption Date, by paying in cash therefor, $_____ per share of Preferred Stock (as adjusted for any stock dividends, combinations or splits with respect to such shares) plus all declared or accumulated but unpaid dividends on such shares (the "Redemption Price"); provided, however, that the Corporation shall not be required under this paragraph to redeem from any particular holder (i) in connection with the initial Redemption Date upon which such holder's shares of Preferred Stock are being

redeemed, a number of shares of Preferred Stock greater than _____% of the aggregate number of shares of Preferred Stock held by such holder immediately prior to such redemption, and (ii) in connection with the second Redemption Date upon which such holder's shares of Preferred Stock are being redeemed, a number of shares of Preferred Stock greater than fifty percent (50%) of the aggregate number of shares of Preferred Stock held by such holder immediately prior to such redemption.

[Version 4 - Redemption at the Option of the Corporation]

Subject to the rights of Preferred Stock which may from time to time come into existence, this corporation may at any time it may lawfully do so, at the option of the Board of Directors, redeem in whole or in part the Preferred Stock by paying in cash therefor a sum equal to the Redemption Price. Any redemption effected pursuant to this paragraph shall be made on a pro rata basis among the holders of the Preferred Stock in proportion to the number of shares of Preferred Stock then held by them.

ANTIDILUTION PROTECTION

Conversion Price Adjustments of Preferred Stock for Certain Dilutive Issuances. The Conversion Price of the Preferred Stock shall be subject to adjustment from time to time as follows:

If the corporation shall issue, after the date upon which any shares of Preferred Stock were first issued (the "Purchase Date" with respect to such series), any Additional Stock (as defined below) without consideration or for a consideration per share less than the Conversion Price for such Series in effect immediately prior to the issuance of such Additional Stock, the Conversion Price for such Series in effect immediately prior to each such issuance shall forthwith (except as otherwise provided in this clause) be adjusted

[Ratchet Formula: to a price equal to the price paid per share for such Additional Stock.**]**

[Narrow-Based Formula: to a price equal to the quotient obtained by dividing the total computed under clause (x) below by the total computed under clause (y) below as follows:

(x) an amount equal to the sum of

(1) the aggregate purchase price of the shares of the Preferred Stock sold pursuant to the agreement pursuant to which shares of Preferred Stock are first issued (the "Stock Purchase Agreement"), plus

(2) the aggregate consideration, if any, received by the corporation for all Additional Stock issued on or after the Purchase Date for such series;

(y) an amount equal to the sum of

(1) the aggregate purchase price of the shares of Preferred Stock sold pursuant to the Stock Purchase Agreement divided by the Conversion Price for such shares in effect at the Purchase Date for such series, plus

(2) the number of shares of Additional Stock issued since the Purchase Date for such series.**]**

[Broad-Based Formula: to a price determined by multiplying such Conversion Price by a fraction, the numerator of which shall be the number of shares of Common Stock outstanding immediately prior to such issuance plus the number of shares of Common Stock that the aggregate consideration received by the corporation for such issuance would purchase at such Conversion Price; and the denominator of which shall be the number of shares of Common Stock outstanding immediately prior to such issuance plus the number of shares of such Additional Stock. For the purpose of the above calculation, the number of shares of Common Stock immediately prior to such issuance prior to such issuance shall be calculated on a fully-diluted basis, as if all shares of Preferred Stock had been fully converted into shares of Common Stock and any outstanding warrants, options or other rights for the purchase of shares of stock or convertible securities had been fully exercise as of such date.**]**

"Additional Stock" shall not include:

(i) securities issuable upon conversion of any of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other

convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; and (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [_____] Series A Director(s)] [(v) shares of Common Stock issued or issuable to banks, equipment lessors pursuant to a debt financing, equipment leasing or real property leasing transaction approved by the Board of Directors of the Corporation [, including at least [_____] Series A Director(s)].

PAY-TO-PLAY PROVISIONS

The below paragraph provides standard language for a pay-to-play provision. Inclusion of this provision will require the authorization of a derivative series of preferred stock (e.g., Series A-1 Preferred Stock) which typically has all the attributes of the original series of preferred stock, except for the price-based antidilution rights, other antidilution rights, protective provisions or other rights. Sometimes, the Preferred Stock converts to Common Stock.

Special Mandatory Conversion.

(i) At any time following the Purchase Date, if (a) the holders of shares of Preferred Stock are entitled to exercise the right of first offer (the "Right of First Offer") set forth in Section ___ of the **[**Investors' Rights Agreement**]** dated _____ by and between this corporation and certain investors, as amended from time to time (the "Rights Agreement"), with respect to an equity [or debt] financing of the corporation (the "Equity Financing"), (b) this corporation has complied with its notice obligations, or such obligations have been waived, under the Right of First Offer with respect to such Equity Financing and this corporation thereafter proceeds to consummate the Equity Financing and (c) such holder (a "Non-Participating Holder") does not by exercise of such holder's Right of First Offer acquire his, her or its Pro Rata Share (as defined in Section ___ of the Rights Agreement) offered in such Equity Financing (a "Mandatory Offering"), then all of such Non-Participating Holder's shares of Preferred Stock shall automatically and without further action on the part of such holder be converted effective upon, subject to, and concurrently with, the consummation of the Mandatory Offering (the "Mandatory Offering Date") into an equivalent number of shares of **[**Series A-1 Preferred Stock**]**; provided, however, that no such conversion shall occur in

connection with a particular Equity Financing if, pursuant to the written request of this corporation, such holder agrees in writing to waive his, her or its Right of First Offer with respect to such Equity Financing. Upon conversion pursuant to this paragraph, the shares of Preferred Stock so converted shall be cancelled and not subject to reissuance.

(ii) The holder of any shares of Preferred Stock converted pursuant to this paragraph shall deliver to this corporation during regular business hours at the office of any transfer agent of the corporation for the Preferred Stock, or at such other place as may be designated by the corporation, the certificate or certificates for the shares so converted, duly endorsed or assigned in blank or to this corporation. As promptly as practicable thereafter, this corporation shall issue and deliver to such holder, at the place designated by such holder, a certificate or certificates for the number of full shares of the [Series A-1 Preferred Stock] to be issued and such holder shall be deemed to have become a shareholder of record of [Series A-1 Preferred Stock] on the Mandatory Offering Date unless the transfer books of this corporation are closed on that date, in which event he, she or it shall be deemed to have become a shareholder of record of [Series A-1 Preferred Stock] on the next succeeding date on which the transfer books are open.

(iii) In the event that any [Series A-1 Preferred Stock] shares are issued, concurrently with such issuance, this corporation shall use its best efforts to take all such action as may be required, including amending its Articles of Incorporation, (a) to cancel all authorized shares of [Series A-1 Preferred Stock] that remain unissued after such issuance, (b) to create and reserve for issuance upon Special Mandatory Conversion of any [Series A] Preferred Stock a new Series of Preferred Stock equal in number to the number of shares of [Series A-1 Preferred Stock] so cancelled and designated [Series A-2 Preferred Stock], with the designations, powers,

preferences and rights and the qualifications, limitations and restrictions identical to those then applicable to the [Series A-1 Preferred Stock], except that the Conversion Price for such shares of [Series A-2 Preferred Stock] once initially issued shall be the Series A Conversion Price in effect immediately prior to such issuance and (c) to amend the provisions of this paragraph to provide that any subsequent Special Mandatory Conversion will be into shares of Series ___-2 Preferred Stock rather than Series ___-1 Preferred Stock. This corporation shall take the same actions with respect to the Series ___-2 Preferred Stock and each subsequently authorized Series of Preferred Stock upon initial issuance of shares of the last such Series to be authorized. The right to receive any dividend declared but unpaid at the time of conversion on any shares of Preferred Stock converted pursuant to the provisions of this paragraph shall accrue to the benefit of the new shares of Preferred Stock issued upon conversion thereof.**]**

PROTECTIVE PROVISIONS

Subject to the rights of Preferred Stock which may from time to time come into existence, so long as any shares of Preferred Stock are outstanding, this corporation shall not without first obtaining the approval (by vote or written consent, as provided by law) of the holders of **[**Preferred Stock which is entitled, other than solely by law, to vote with respect to the matter (including, without limitation, the Preferred Stock), and which Preferred Stock represents at least a majority of the voting power of the then outstanding shares of such Preferred Stock**] [**at least a majority of the then outstanding shares of Preferred Stock**]**:

(a) sell, convey, or otherwise dispose of or encumber all or substantially all of its property or business or merge into or consolidate with any other corporation (other than a wholly-owned subsidiary corporation) or effect any transaction or series of related transactions in which more than fifty percent (50%) of the voting power of the corporation is disposed of;

(b) alter or change the rights, preferences or privileges of the shares of Preferred Stock so as to affect adversely the shares;

(c) increase or decrease (other than by redemption or conversion) the total number of authorized shares of Preferred Stock;

(d) authorize or issue, or obligate itself to issue, any other equity security, including any other security convertible into or exercisable for any equity security **[**(i)**]** having a preference over, or being on a parity with, the Preferred Stock with respect to voting, dividends or upon liquidation**[**, or (ii) having rights similar to any of the rights of the Preferred Stock under this Section 6;

(e) redeem, purchase or otherwise acquire (or pay into or set aside for a sinking fund for such purpose) any share or shares of Preferred Stock or Common Stock; provided, however, that this restriction shall not apply to (i) the repurchase of shares of Common Stock from employees, officers, directors, consultants or other persons performing services for the Company or any subsidiary pursuant to agreements under which the Company has the option to repurchase such shares at cost or at cost upon the occurrence of certain events, such as the termination of employment **[**provided further, however, that the total amount applied to the repurchase of shares of Common Stock shall not exceed $_____ during any twelve (12) month period**]** or (ii) the redemption of any share or shares of Preferred Stock otherwise than by redemption in accordance with subsection __;

(f) amend the Corporation's certificate of incorporation or bylaws;

(g) change the authorized number of directors of the corporation;

(h) enter into any financial commitments or expenditures over $_____;

(i) create any material liens upon the assets and properties of the Corporation;

(j) exclusively license all or substantially all of the Corporation's intellectual property in a single transaction or series of related transactions; or

(k) engage in substantial acquisitions or changes in business or enter into any new lines of business, joint venture or similar arrangement.

APPENDIX B

ILLUSTRATION OF ANTI-DILUTION ADJUSTMENTS

A startup company, the Next Best Thing, Inc., which develops cutting edge widgets, is incorporated. The founders believe that given the success of other companies in the same industry and the then current market conditions, the company can go public in a few years. The company issues common stock to its two founders and thereafter, has the following capitalization structure:

	# of Shares	%
Common Stock (founders)	3,500,000	77.78%
Stock Option/Stock Issuance Plan (shares reserved)	1,000,000	22.22%
TOTAL	4,500,000	100%

Seed Financing

Two months after the company's incorporation, the founders reached the limit on their credit cards for the initial costs incurred in starting and operating the company. In this regard, one of the founder's mentors (the "Angel Investor"), agreed to invest $50,000 in seed money into the company, so as to allow the Company to continue operating its business until it is able to receive venture financing.

In exchange for the $50,000 in seed money, the Angel Investor received 500,000 shares of Common Stock at a purchase price of $0.10 per share.

After the infusion of the $50,000 equity investment from the angel investor, the capitalization of the company, including the corresponding ownership percentage of the company, was as follows:

	# of Shares	%
Common Stock (founders)	3,500,000	70%
Common Stock (angel investor)	500,000	10%
Stock Option/Stock Issuance Plan (shares reserved)	1,000,000	20%
TOTAL	5,000,000	100%

Series A Financing

Later, after making significant advances in its research and development efforts, the company sought $5 million in venture capital, and received three term sheets, negotiating a $5 million pre-money valuation. After weighing these term sheets, the company selected its investors and entered into definitive investment agreements. The purchase price was $1.00 per share of Series A preferred stock, representing the pre-money valuation of $5 million (5,000,000 shares with a value of $1.00 per share). Post-financing, the capitalization of the company, including the corresponding ownership percentage of the company, was as follows:

	Pre-Financing		Post-Financing	
Capitalization	# of Shares	%	# of Shares	%
Series A Preferred stock	0	0%	5,000,000	50%
Common Stock (founders)	3,500,000	70%	3,500,000	35%
Common Stock (angel investor)	500,000	10%	500,000	5%
Stock Options	1,000,000	20%	1,000,000	10%
Total Number of Shares	5,000,000		10,000,000	

Series B Financing

Thereafter, the company released a beta version of its technology and received favorable reviews from customers. However, the company required an additional $10 million to complete the commercial roll-out of its product. Accordingly, the company sought additional investors. Within months, the company negotiated a $20 million pre-money valuation with a new lead investor and its existing investors. The purchase price was $2.00 per share of Series B preferred stock, representing a pre-money valuation of $20 million (10,000,000 shares with a value of $2.00 per share).

Post-financing, the capitalization of the company, including the corresponding ownership percentage of the company, was as follows:

	Pre-Financing		Post-Financing	
Capitalization	# of Shares	%	# of Shares	%
Series B Preferred stock	0	0%	5,000,000	33.33%
Series A Preferred stock	5,000,000	50%	5,000,000	33.33%
Common Stock (founder)	3,500,000	35%	3,500,000	23.33%
Common Stock (angel investor)	500,000	5%	500,000	3.33%
Stock Options	1,000,000	10%	1,000,000	6.67%
Total Number of Shares	10,000,000		15,000,000	

Series C Financing

Within the next nine months, the company had signed up three customers and had generated significant revenues. Despite its three customers and the experiences of other

companies within the last year, the company was not yet ready to go public and had to raise $36 million of additional capital. The company negotiated a $90 million pre-money valuation with investors. The purchase price was $6.00 per share of Series C preferred stock, representing a pre-money valuation of $90 million (15,000,000 shares with a value of $6.00 per share).

In conjunction with the financing, the board recognized that the company needed to increase the size of its stock option pool to attract and retain its talent, and subject to stockholder approval, approved an increase, on a post-financing basis, of the stock option pool by 3,000,000 shares.

Post-financing, the capitalization of the company, including the corresponding ownership percentage of the company, was as follows:

	Pre-Financing		Post-Financing	
Capitalization	# of Shares	%	# of Shares	%
Series C Preferred stock	0		6,000,000	25%
Series B Preferred stock	5,000,000	33.33%	5,000,000	20.83%
Series A Preferred stock	5,000,000	33.33%	5,000,000	20.83%
Common Stock (founder)	3,500,000	23.33%	3,500,000	14.58%
Common Stock (angel investor)	500,000	3.33%	500,000	2.08%
Stock Options	1,000,000	6.67%	4,000,000	16.67%
Total Number of Shares	15,000,000		24,000,000	

Series D Financing

Now, the company has released the second version of its product but has only signed up a total of seven customers, less than the number of customers anticipated in the company's business plan. While the company has significant revenues, it needs an additional $10 million to expand its marketing capabilities to reach profitability. However, the capital markets are closed to the company and the stock price of public companies in the same industry have declined tremendously. Given this environment, the company can only negotiate a $30 million pre-money valuation, which is approximately a 67% decrease in valuation. The purchase price is $1.25 per share of Series D preferred stock, representing a pre-money valuation of $30 million (24,000,000 shares with a value of $1.25 per share).

Because the Series D financing will be a "down round," as discussed above (the price per share of Series D preferred stock is less than the price paid in the previous Series C round of financing), there will be anti-dilution adjustments in accordance with the rights governing the preferred stock, as set forth in the articles/certificate of incorporation. The chart below indicates the number of shares of each series of preferred stock, as calculated using the broad based, narrow-based and full ratchet anti-dilution adjustments, which are discussed above.

A basic broad based weighted average anti-dilution formula may be expressed as follows:

$$NCP = CP * \frac{CS + (AC/CP)}{CS + AS}, \quad \text{where}$$

CS = Common stock outstanding (on a fully converted basis) prior to the dilutive issuance,

AC = Aggregate consideration paid for the securities causing the dilutive adjustment,

CP = Conversion price prior to the adjustment of the series of preferred stock being adjusted,

AS = Number of shares of securities (on an as-converted basis) causing the dilutive issuance, and

NCP = New conversion price.

In applying the broad based weighted average formula using the capitalization of the company, the "new" Series B conversion price would be $0.75 per share, and thus the conversion ratio for the Series B preferred stock would be $1.00/$0.75 = 1.33. As a result of this higher conversion ratio, the company would need to issue 1,666,666 additional shares of common stock upon conversion to the holders thereof, in order for the holders to maintain their ownership percentage of the company. Similarly, the "new" Series C conversion price would be $1.50 per share, and thus the conversion ratio for the Series B preferred stock would be $2.00/$1.50 = 1.33. As a result of this higher conversion ratio, the company would need to issue 2,000,000 additional shares of common stock upon conversion to the holders thereof, in order for the holders to maintain their ownership percentage of the company. In sum, the company using this broad based weighted average formula would issue an additional 3,666,666 shares of common stock due to the down round, and the percentage ownership of the common stockholders would decrease from an aggregate of 16.66% to 11.21% post financing.

A basic narrow based weighted average formula may be expressed as follows:

NCP = (X1 + X2) / (Y1 + Y2), where

NCP = New conversion price,

X1 = Aggregate consideration paid for shares of series of preferred stock with respect to which adjustment is being made,

X2 = Aggregate consideration paid for additional stock since the date of first issuance of series of preferred stock with respect to which adjustment is being made,

Y1 = Number of issued shares of series of preferred stock with respect to which adjustment is being made, and

Y2 = Number of shares of Additional Stock issued since the applicable Purchase Date.

In applying the narrow based weighted average formula using the capitalization of the company, the "new" Series C conversion price would be $3.28 per share, and thus the conversion ratio for the Series C preferred stock would be $6.00/$3.28 = 1.83. As a result of this higher conversion ratio, the company would need to issue 4,956,522 additional shares of common stock upon conversion to the holders thereof, in order for the holders to maintain their ownership percentage of the company. Note that the company would not issue additional shares of Series B preferred stock. In sum, the company using a narrow based weighted average formula would issue an additional 4,956,522 shares of common stock upon conversion due to the down round, and the percentage ownership of the common stockholders would decrease from an aggregate of 16.66% to 10.82% post financing.

As discussed above, with a full ratchet adjustment, the price per share of the diluted stock would automatically decrease to the per share price of the dilutive stock. In the above case, the full ratchet adjustment would require the company to issue an additional 25,800,000 shares of common stock upon conversion, and the percentage ownership of the common stockholders would decrease from an aggregate of 16.66% to 6.93% post financing.

If the valuation of the company were decreased even further, which is not unheard of in this current environment, the company would be even further diluted and issue additional shares of preferred stock.

As you can see, lawyers cannot fear math in this area of practice.

Post-financing and depending on the anti-dilution protection afforded to the preferred stock, the capitalization of the company is as follows*:

	Pre-Financing		Broad Based		Narrow Based		Full Ratchet	
	No. of Shares	% Ownership	No. of Shares	% Ownership	No. of Shares	% Ownership	No. of Shares	% Ownership
Series D Preferred stock	0	0%	8,000,000	22.43%	8,000,000	21.65%	8,000,000	13.84%
Series C Preferred stock	6,000,000	25%	8,000,000	22.43%	10,956,522	29.65%	28,800,000	49.83%
Series B Preferred stock	5,000,000	20.83%	6,666,666	18.69%	5,000,000	13.53%	8,000,000	13.84%
Series A Preferred stock	5,000,000	20.83%	5,000,000	14.01%	5,000,000	13.53%	5,000,000	8.65%
Common Stock (founder)	3,500,000	14.58%	3,500,000	9.81%	3,500,000	9.47%	3,500,000	6.06%
Common Stock (angel investor)	500,000	2.08%	500,000	1.40%	500,000	1.35%	500,000	0.87%
Stock Options	4,000,000	16.67%	4,000,000	11.21%	4,000,000	10.82%	4,000,000	6.91%
Total Number of Shares	24,000,000		35,666,666		36,956,522		57,800,000	

*These calculations assume that the new investor does not require a recalculation of the new per share price after the antidilution shares are issued, which results in circular multiple adjustment calculations. Often new and existing investors negotiate the number of antidilution adjustments that will be made in connection with a particular financing.