Chapter 15

Venture Capital Financing

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I. SCOPE

§ 15:1 In general

Venture capital is the lifeblood of emerging growth financing in the United States if not the world. This chapter seeks to educate attorneys and businesspeople working with small and middle sized emerging businesses about the nature and nuances of this critical and often misunderstood type of financing.

This chapter provides an overview of various components in any venture capital financing transaction: participants' respective concerns and expectations; an example of a business using venture capital financing to illustrate the various stages the business will pass through; the fundamental issues arising in a venture capital financing in detail, including the critical issue of how the business receiving the financing should be valued; how the respective parties might expect to share increases in value; a brief review of the documenta-

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tion for a venture capital transaction; the appropriate form of organization for a business that may be seeking venture capital financing; and finally a brief overview of equity based compensation arrangements and their tax aspects.

II. VENTURE CAPITAL FINANCING: THE LIFEBLOOD OF GROWING ENTREPRENEURIAL BUSINESSES

§ 15:2 The role of venture capital in the U.S

Venture capital fund investors ("VC" or "VCs") are professional investors who specialize in funding and building young, innovative enterprises. VCs are long-term investors who take a hands-on approach with all of their investments and actively work with entrepreneurial management teams in order to build great companies.

In 2010, there were 462 "active" U.S. venture capital firms, i.e. firms which invested at least $5 million in target portfolio companies, and a total of 791 firms. This represents a precipitous decline from 1,022 such firms at the height of the tech bubble in 2000. These firms managed $176.7 billion in committed capital. In 2010, the average venture fund size was $149 million. Given the rapid improvements in and declining costs of technology (storage, infrastructure software for financial and other back office requirements, and processing power) as well as marketing (CRM and other sale and distribution tools), the investment required to launch emerging growth companies has been reduced by, what some estimate as, a factor of 10 over the past 10 years. This dramatic reduction allows the same investment dollars to be spent more productively and focused on the core business instead of the infrastructure.

In 2010, VCs invested approximately $22 billion into nearly 2,749 companies. Of these, 1,001 companies received funding for the first time.

VCs invest mostly in young, private companies that have great potential for innovation and growth. They have been instrumental in developing sectors such as the computer, biotechnology and the communications industries. Today, the majority of venture capital is invested in high technology companies including software, biotechnology, medical devices, media and entertainment, wireless communications, Internet, and networking. In the last five years, the VC industry has also committed itself to investing in the clean

technology sectors which include renewable energy, environmental and sustainability technologies and power management. However, VCs also invest in innovative companies within more traditional industries such as consumer products, manufacturing, financial services, healthcare services, and business products and services.

Despite uncertainty in the U.S. economy, and despite criticism of the industry (and its private equity compatriots) being "locusts," the VC industry and its support for early-stage companies has helped create jobs, innovation, technology advancement, and increased tax revenues. According to the 2011 Venture Impact study, produced by IHS Global Insight, originally venture-backed companies accounted for 11.87 million jobs and over $3.1 trillion in revenue in the United States (based on 2010 data). Those totals compare to 21% of GDP and 11% of private sector employment.

Most VC firms raise their funds from institutional investors, such as pension funds, insurance companies, endowments, foundations, family offices, and high net worth individuals. The VCs managing the funds have a fiduciary responsibility to their fund investors.

§ 15:3 Distinguishing characteristics of a venture capital investor

Venture capital is a subset of private equity ("PE") investing. VCs are long-term investors who take a very active role in their portfolio companies. When a VC makes an investment in a portfolio company, the fund does not expect a return on that investment for seven to 10 years, on average. The initial investment is just the beginning of a long relationship between the VC and entrepreneur. VCs provide great value by providing capital and management expertise. VCs often are invaluable in building strong management teams, managing rapid growth, and facilitating strategic partnerships.

The main distinguishing characteristics of a VC fund investment and other forms of private equity investment are: the VC fund typically obtains a minority interest whereas the typical PE fund seeks control of the company in which an investment is being made (the "Target"). Further, the VC investment is, by definition, at an earlier stage in the Target's life cycle. Therefore, the VC-backed company often needs to pay much more attention to the management and

development of its technology than a PE-backed company which provides either growth or rescue capital. Finally, a VC-backed company will not be "bankable" or have any bank debt. In many cases, the VC-backed company will not even have positive cash flow, as it continues to develop its products and markets. A PE-backed company, in contrast, is often leveraged with considerable amount of bank and often mezzanine debt, and is hopefully cash flow generating in order to service those obligations.

§ 15:4 How do venture capitalists analyze a possible investment?

The VC will analyze a possible transaction by using two methodologies, an "objective" economic valuation approach and a more subjective business analysis. The more subjective business analysis evaluates five basic components of the Target:

- *Management Team.* How talented and experienced is the Target's management team? How mature? How businesslike? What ethical and moral virtues and values do they have? How receptive are they to professional VC involvement?
- *Business Model.* How realistic is the Target's business model? How scalable (i.e., able to grow and repeat) is it? How novel is it?
- *Technology or Product.* How novel is the technology or product produced by the Target? How is it different than or competitive with the technology or products of others? How protectable is the technology or product—for example, is it susceptible to infringement or can it be designed around? As Warren Buffet would ask: how "wide a moat" is there protecting the intellectual property?
- *Competition.* How much is there for the Target? How well capitalized? How focused on the threat from the Target?
- *Size of Potential Market.* How large is the Target's potential market? Is this just a niche market or is there some real large opportunity? What sort of growth potential is there?

III. BASIC STAGES AND STRUCTURES OF A VENTURE CAPITAL INVESTMENT

§ 15:5 Investment stages

A typical Target will evolve through various stages during its life cycle. Overlapping and contradictory terminology is often used to describe these various stages. Some call the "early stage" the "start-up" stage, and others call it the "first stage." The terminology is not important; it is the concepts that are critical.

§ 15:6 Investment stages—Early stage

The early stage is the initial formative stage of a Target. Early stage venture capital financing occurs typically after the "angel" round involving a rich patron and sometimes successful entrepreneur investors (as well as the entrepreneur's own cash, if any, as well as borrowings from friends, family, and credit card companies).

In the first half of 2011, approximately 16% of all VC investments were made at the startup stage. The average size VC investment at this stage was a little over $1 million.

The early stage is typically the most dilutive stage to the existing owners since the risk to the VC investors is highest, and the negotiating leverage of the entrepreneur who began the business or the existing management team (in this chapter, such persons are referred to generically as the "founder") is lowest. A savvy founder, therefore, will balance trying to raise as much money as necessary with the desire to retain as much equity as possible so that less equity will have to be sacrificed in the subsequent stages. A wise founder will also attempt to obtain a VC who has great credibility and respect in the VC world. This sage VC will inoculate the Target with a patina of credibility and respect that may induce other investors to make commitments at this or later stages of financing.

The early stage can be broken down into two phases—the seed money phase and the start-up phase.

The first of these phases, the seed money phase is where an angel or VC investor will infuse between $100,000 and $500,000 to cover the Target's formation and initial research and development costs. Dramatic advances in technology have dramatically reduced the costs necessary to start up a business. Cloud computing, memory and power of comput-

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ers, and marketing and finance tools all serve to enable a Target to spend more of its cash on developing its product. Little or no revenues have been generated at this point. Biotechnology or software development firms typify investments in the seed money phase of the early stage. Lenders (except credit card lenders) are usually unwilling to loan to the Target or its founders at this stage since there is little or no collateral.

The second phase of the early stage is the start-up phase. At this phase, the Target has almost completed product development and begun initial testing or marketing of its product. The Target has perhaps started to generate revenues, but losses or working capital demands far exceed these revenues. Lenders may be more willing to loan at this point, but their appetite for nonrecourse loans is doubtful. Additional equity investment, typically in the range of $500,000 to $10 million, can be expected at this stage. High technology companies beginning to ship or license their products and newly-formed fast-food restaurants and light manufacturing businesses are illustrative of start-up phase investments.

§ 15:7 Investment stages—Growth stage

As the Target grows, it needs new capital either to fund working capital (customers do not always pay as fast as suppliers demand payment), fund operating deficits, purchase additional plant and equipment, or purchase new businesses or product lines. This capital usually is provided in new "rounds" of financing. A Target will frequently go through several additional rounds of financing prior to its ultimate initial public offering ("IPO") or liquidating event (such as a sale or merger).

The additional rounds of financing may be simply "add-on" or additional investments by the investors who made early stage investments, or new VCs may be brought in as well. Whether new VCs are brought in the growth stage or whether the existing VC makes add-on investments at a higher price per share, the Target will now be able to leverage itself with debt since it now has a successful track record and presumably is generating free cash flow from which to service debt.

§ 15:8 Structure of investments

The structure of a VC investment will inherently be a func-

tion of the stage of the Target, the Target's past history and current needs, and the goals and creativity of the parties. While we could devote an entire treatise to differing structures of VC investments at the various stages, we will consider a fairly typical example.

§ 15:9 Structure of investments—Formation

Upon formation of the Target, the founders will issue stock (or equivalent interests such as limited liability company units) to themselves at very low prices. For example, two founders may initially invest $1,000 each for 1 million shares each, par value $0.01 per share.

The capital structure of the Target will look like this:

Type of Investment	Holder	Investment	Shares	Percentage of Common
Common	Founders	$2,000	2 million	100%
Total		$2,000	2 million	100%

§ 15:10 Structure of investments—Friends, family and angel investments

Once the founders have created a business plan, developed contacts and interest with customers and suppliers, and perhaps even beta tested a product and have taken other certain preliminary steps which would attract some investment interest, they may be fortunate enough to have wealthy friends, family, or be able to find a few willing participants to invest in the Target ("angels"). The form of this investment is typically structured as a bridge loan or common stock.

If a bridge loan is made, it is repaid if no VC or additional source of capital is found within a certain period of time (such as six to 12 months). If a VC is found, the bridge loan is converted to the same security which the VC purchases at either the VC's price or a fraction thereof.

If common stock is purchased, the first step is to value the Target. Valuation is always an art, not a science, and is especially subjective and evanescent at this point. If a $1 million value is ascribed to the Target before friends, family, and angels invest (which is called a "pre-money value") and

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the friends, family, and angels invest $250,000, they will collectively own 20% of the Target (i.e., $250,000 divided by the sum of $1 million pre-money value plus the $250,000 investment).

After friends, family, and angels purchase stock, the capital structure of the Target will look like this:

Type of investment	Holder	Investment	Shares	Percentage of Common
Common	Friends/ Family/Angels	$250,000	500,000	20%
	Founders	$2,000	2 million	80%
Total		$252,000	2.5 million	100%

§ 15:11 Structure of investments—Early-stage venture capital

The Target may now need, for example, $1 million to beta test the software it intends to market and perhaps to start a sales effort. The founders and VC agree that the Target is now worth $4 million before the VC's investment. Therefore, the VC's $1 million investment would entitle it to 20% of the fully-diluted equity of the Target.

The structure of the VC's investment is typically in the form of convertible preferred stock. Sometimes you will see straight preferred stock which requires payment in full before common shareholders are entitled to receive any distributions plus warrants issued to the VC to purchase common.

Ownership of convertible preferred stock will enable the VC to have the best of both worlds. If the Target does not succeed and is liquidated or undergoes a change in control not involving an IPO (such as a sale, merger or other event), the instrument will give the VC a liquidation preference over the founders and other common shareholders. If the Target does well and is sold or merged for a substantial premium or flourishes after an IPO, then the convertible preferred stock will enjoy the upside appreciation inherent in common stock.

The design of the convertible preferred stock is frequently contested during the negotiations. Design issues include the dividend rate, whether dividends accrue, whether dividends are payable upon a conversion or only on a liquidating event or redemption, what rights the holder of the preferred has to seats on the board of directors of the Target, whether the number of seats increases if certain milestones (financial or otherwise) fail to be met, what exit rights the holder of preferred stock has, and what the participating features are and the limits thereon. The VC's preferred stock will frequently be required to convert to common upon an IPO.

After the VC invests in preferred stock, the Target's capital structure will look like this:

Type of Investment	Holder	Investment	Shares	Percentage of Common
Convertible Preferred	VC	$1 million	625,000 (upon conversion of preferred stock at $1.60 per share)	20%
Common	Friends/ Family/Angels	$250,000	500,000	16%
	Founders	$2,000	2 million	64%
Total		$1,252,000	3.125 million	100%

Note that the price per share of common stock increased during each round of financing. The founders paid $0.01 per share. The friends, family, and angels paid $0.50 per share. Now the VC is paying $1.60 per share. The low valuation for the founders has enabled them to keep 64% of the Target's common stock although they invested less than one-tenth of 1% of the cash investment. This chart can be expanded as additional rounds of financing occur.

§ 15:12 Structure of investments—Management capital

As additional rounds progress, the owners may agree that it is necessary to set aside equity to attract, incentivize, and retain the management team. Option pools typically range

from 10 to 25% of a Target's equity. The options or stock reserved for the management team will typically dilute all owners proportionately. However, a VC will sometimes argue that it should not be diluted or at least not diluted in the same proportion as other owners. In the example below, we have assumed a valuation of $0.50 per share (or a strike price of $0.50 per share for each option) for 15% of the ownership of the Target is made available to the management team. This would equate to approximately 555,000 shares for a price of $277,500.

After issuing options to the management team and their full exercise of the options, the Target's capital structure will look like this:

TYPE of Investment	Holder	Investment	Shares	Percentage of Common
Convertible Preferred	VC	$1 million	625,000 (upon conversion to common) at $1.60 per share	17%
Common	Management/Employee Pool	$277,500	555,555	15%
	Friends/ Family/ Angels	$250,000	500,000	14%
	Founders	$2,000	2 million	54%
Total		$1,529,500	3,680,555	100%

§ 15:13 Obligation to close

The right of a VC to be relieved of its obligation to close has become a significant issue in recent years. The issue is more prevalent in PE transactions due to the sometimes considerable time lag between signing documents and closing (due to regulatory approvals and other delays) and less prevalent in VC deals since many are signed and closed simultaneously. The most hotly contested issue in recent years which has excused closing due to the occurrence of a "material adverse change" in the Target is often not present in early stage companies since the investment is not typi-

cally predicated on the financial condition of the Target but rather on the specific measureable milestones or events.

IV. VALUATION OF THE BUSINESS AND OWNERSHIP PERCENTAGES

§ 15:14 Basic approaches to valuation

Valuation of the Target is key to determining the ownership interest that the VC's investment will purchase and the range of nonmonetary rights the VC may seek to obtain. At the risk of oversimplifying three university courses on finance, valuation will be made using one or more of the following basic approaches:

- *Comparable Businesses.* The first basic approach to valuation looks at what businesses comparable to the Target have sold for. In the jargon of the particular industry, the sales price may be a multiple of earnings, cash flow (i.e., earnings after adding back interest, taxes, and depreciation expense and amortization charges ("EBITDA")), modified EBITDA (by providing for changes in working capital, adjusting for capital spending, and taking out or adding back extraordinary items or costs which should be normalized), multiple of book value or revenues, or some other standard formula. At the VC stage, however, these metrics are usually not present since EBITDA is a far-off dream. At best, a metric may be a multiple of revenues.
- *Replacement Cost.* The second basic approach to valuation looks at what it would cost to replace the assets and going concern value of the Target's business. This replacement cost method addresses the perennial issue of "buy versus build." The prospective investor adds up the sum of all of the parts—the buildings, distribution channels, reserves, brand name recognition, etc.—to gauge what it would actually cost to duplicate the business. Again, this metric is difficult, if not impossible, to gauge accurately, particularly in an early stage investment.
- *Discounted Cash Flow/Internal Rate of Return.* The third basic approach to valuation looks to the future of the business, unlike the comparable business approach, which looks at the past, and the replacement value approach, which looks at the present. The third basic approach attempts to estimate the future cash flow

streams of the business, including the cash from an anticipated sale some time in the future, and discount those cash flow streams back to the present by using a reasonable discount or "hurdle" rate. The discount rate will be higher based upon perceived risk and uncertainty that the projected results will be achieved. If the amount equal to the proposed investment less the discounted present value of the cash flow stream exceeds zero, the investment makes sense. Given the highly speculative nature of what free cash flow is likely to be many years out in the future and the appropriate discount rate, this approach is of questionable utility in a VC-backed company as well.

The reader can now appreciate that valuation of a VC-backed company is probably more of an art than a science. VCs will often intuit that their investment will be binary—it will either generate a multiple return or be worth nothing. Therefore, the real valuation debate is as much visceral as analytical—what do the VC's instincts tell it that an early-stage company should be worth and how much ownership does it feel it needs?

VCs typically take two approaches to determining what percentage of the Target their investment will buy. The "inside out" approach determines what the Target is worth and what the investment will buy. For example, if the business is worth $1 million and $1 million of capital is needed, then the VC will seek a 50% ownership interest.

More typically, particularly in early stage investments, the VC adopts the "outside in" approach. It applies its desired return on investment in order to value the Target. For example, if the Target is worth $1 million today, the VC desires a 35% internal rate of return on its $1 million investment, and believes the equity of the Target will be worth $5 million in five years, then the VC must own 56% of the common stock to achieve that desired return.

§ 15:15 Determination of ownership percentage—Vesting

A VC's ownership interest may also functionally increase if founders and employees' interests are contingent on or subject to reduction due to concepts of vesting.

The right to exercise options to the Target's management employees may only vest over time and perhaps based on

performance. The purpose of vesting is to tie the management team to the business for a period of time and to assure that managers do not reap a windfall if they have not put in the required effort. Further, since ownership in the business is needed to attract, retain, and motivate management, vesting serves as a basis for recovering some ownership interests from departed personnel. Those recovered interests, in turn, can be used to attract and compensate replacement management personnel.

A fairly common vesting schedule may be over three to five years typically linearly (perhaps with some shares already vested and often with a monthly, quarterly or annual straight-line vesting schedule). If the bulk of the hard work and effort is in the early stages (e.g., if a telephone system needs to be built out over the first couple of years before operations can begin), the vesting may be front-loaded. Conversely, if the VC believes that management's full attention is needed over the entire four years, it may backload or cliff base the vesting, so that, in the most egregious case, if a manager leaves the Target on the third year and 364th day, the manager's vesting percentage would be zero.

The vesting schedule typically accelerates upon the sale of the Target or its business, termination of a manager's employment with the Target without cause, and death. Sometimes the acceleration rate is 100%, and sometimes it is a smaller percentage. Conversely, the vesting percentage is typically zero if a manager's employment with the Target is terminated for cause or the manager breaches a noncompetition or confidentiality covenant.

§ 15:16 Determination of ownership percentage—Clawbacks

As the earlier charts demonstrate, founders typically own a proportionately large percentage of the Target's equity relative to the capital invested. As a result, VCs will often insist on reducing founder equity stakes based on either time based vesting concepts similar to those discussed in the preceding section or based upon the failure to attain certain performance milestones. For example, if a VC is in effect investing in a founder, and that founder leaves within a short period, the underlying premise of the VC investment is undermined and a revaluation of the Target is only fair. Similarly, if a VC valued the Target in part upon the likely attainment of

an FDA license and that license was not issued at the projected time, then the financial assumptions underlying the investment are askew and justify recalibration.

§ 15:17 Determination of ownership percentage—Down rounds

If there is one certainty in VC investments (besides the certainty that there is uncertainty) it is that additional capital will be needed to continue the Target's growth. While everyone hopes and expects that the Target's price per share will rise inexorably, that obviously does not always occur. Market timing, delays in approvals, delays in finishing code, general market driven valuation compression, or just unfortunate budgeting all justify lower valuations for the next round of VC financing.

In many cases, the Target has little or no choice but to accept the lower valuations and hope that the VC does not try to take undue advantage of its increased negotiating power. In many cases, the VC actually wants to soften the dilution which key employees will suffer from the impact of a down round.

To minimize the impact of a down round on key employees, the VC may permit the Target to grant options to key executives at the lower price. A similar technique would be to permit executives to purchase preferred stock, or to give them options to buy preferred stock, at the VC's down round price. These two approaches dilute the interests of earlier round investors, including other founders, but they soften the blow to the key members of the management team and therefore may keep them motivated.

Another way in which a Target can seek to mitigate the effects of a down round is to request the right to redeem the stock purchased by the VC in the down round at some future date. While the VC may argue that treating its investment, in effect, like a loan does not adequately compensate it for its risk and cost of capital, the Target will argue that this is a fair approach to prevent the VC from unfairly exploiting its advantage.

§ 15:18 Determination of ownership percentage—Down rounds—Fiduciary duties

A director of a Target can face potentially serious conflicts of interest in deciding whether to issue a new round of stock

if the price per share is less than the price paid for stock in prior rounds. This potential conflict is particularly acute in the situation of a director appointed to protect the interests of a VC. That director may have a conflict between his or her fiduciary duties to the Target and its shareholders generally on the one hand and the particular interests of the VC on the other. Issuing new stock at a price lower than that paid by the VC may harm the interests of the VC, but issuing such stock may be in the best interests of the Target's shareholders generally.

Short of VC-appointed directors recusing themselves and not participating in the decision to issue stock in a down round or not participating in the decision about the price of that stock, one or more of several precautions should be taken to limit the potential exposure of directors to liability for breach of fiduciary duties:

- Establish an independent committee of the board of directors that does not include the VC directors to evaluate the terms of the proposed financing and negotiate the terms with the new investors;
- Retain an independent valuation company to provide a fairness opinion or appraisal of the value of the stock of the Target;
- Seek to sell at least part of the new stock to a third party who is not already a shareholder of the Target in order to show the fairness of the proposed price;
- Give the existing shareholders of the Target preemptive rights to purchase the new stock in order to protect themselves against dilution resulting from the issuance of the new stock;
- Seek the prior approval of the minority shareholders of the Target, and offer them additional options or other incentives if necessary to secure their approval (recognizing the risk that this could cause the minority to try to use its perceived leverage to extract concessions from the majority); or
- Award minority shareholders additional options or provide other incentives to entice them to approve the transaction.

The directors should, in any case, fully and carefully discuss all of their options, including a merger, sale or licensing of assets, as well new financing. Any interested director should fully disclose his or her conflict, and complete and detailed minutes of directors meetings are critical.

V. DOCUMENTATION

§ 15:19 In general

Nuances in the documentation of a venture capital transaction have nuances and dimensions far beyond the scope of this chapter. Selected significant major issues that are often confronted in these documents are discussed in other sections of this chapter.

The basic documents and their purposes are set forth below.

§ 15:20 Term sheet

The term sheet, which is usually nonbinding (except for certain provisions discussed below), sets forth the salient details of a VC's investment and the related terms and conditions. The term sheet sets forth the amount of the investment, price per share, design of the equity interest that the VC will obtain (including such items as conversion rights and obligations, participating features, coupon rate, dilution protection, and preemptive rights), right to approve certain Target actions, rights to redeem the investment, registration rights, rights to participate on the board of directors of the Target, and conditions to closing such as the execution of employment, noncompetition and confidentiality agreements.

There are two major benefits of the term sheet for the VC. First, it avoids needless and protracted negotiations of the documentation if the Target is not amenable to the fundamental terms. Second, the term sheet requires the Target to make binding commitments on some matters relating to negotiation of the VC's investment. For example, the term sheet frequently gives the VC and its advisors the right, for some period of time, to have the exclusive right to have access to the Target's books, records, properties, customers, suppliers, and personnel in order to conduct a due diligence investigation. The term sheet may also commit the Target not to solicit, entertain, or accept offers from other investors or negotiate with other investors for a period of time. In addition, the term sheet may commit the Target to cover some of the VC's expenses, sometimes even if the transaction is not finalized.

§ 15:21 Purchase agreement

The stock (or LLC unit) purchase agreement is the defini-

tive binding document that sets forth the terms and conditions upon which the VC will invest in the Target. The purchase agreement implements the term sheet and contains the following terms, among others:

- The purchase price for the sale of shares to the VC.
- The closing date.
- Representations and warranties of the Target, such as its due incorporation and authorization to enter into the transaction, title to its assets, the condition of the assets, amount and nature of its liabilities, rights to its intellectual property, its financial condition, absence of litigation against it, and its compliance with laws.
- Representations and warranties of the VC to enable the Target to avail itself of applicable exemptions from the securities laws.
- Conditions to closing, such as the execution of the remainder of the documents discussed below and delivery of a legal opinion from the Target's counsel, authorizing resolutions, and various other items.
- Indemnification of the VC in the event that the Target has breached any of its representations and warranties.

In regard to the last item, it should be noted that the practical remedy for the Target's breach of representations and warranties is often meaningless, especially for a Target in the early stage, since the Target may not have the resources to honor the indemnification obligation. A well-crafted document could seek indemnification from founders in the event of fraud or willful misrepresentation. Other remedies in situations involving significant breaches could be to enable the VC to elect a sufficient number of directors to gain control of the board of directors of the Target, to provide for issuance of additional shares of stock to the VC in lieu of a cash indemnity, or to cause the Target to redeem the VC's shares at cost.

§ 15:22 Investor rights agreement

The Target typically agrees to three basic commitments in an investor rights agreement. First, the Target provides registration rights to the VC. Second, the Target affirmatively covenants to continue to do certain things (such as complying with laws, adhering to budgets, and a whole litany of items) and negatively covenants not to do certain things (such as not sell or merge its business, increase exec-

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utive compensation over a certain threshold, and a whole litany of items). Finally, the Target will agree to give certain information rights to the VC. Information rights may include the provision of interim and year-end financial statements, notices of lawsuits, and notices of defaults or other major items.

Sometimes a separate registration rights agreement is used to deal with the first commitment of the Target. In this case, the second and third commitments may be included in the stock purchase agreement and therefore this agreement may be rendered superfluous.

This agreement is almost always terminated upon a conversion of all of the VC's stock to common, or a sale or IPO. In some cases, the Target may seek to reduce or terminate its obligation upon the VC's reduction of its ownership stake in the Target below an agreed-to level.

§ 15:23 Amended governing documents

The Target's articles of incorporation or operating agreement will need to be amended at the closing of the VC's investment. The amendment will typically set forth, among other things, the design of the preferred security the VC is purchasing. Other amendments may include strengthened indemnification provisions, provisions relating to the election of the Target's board of directors, the VC's rights to approve or reject certain fundamental transactions, and provisions for rights of the VC upon certain events of noncompliance, such as a material breach of the purchase agreement or investor rights agreement.

§ 15:24 Security holders' agreement

The existing Target security holders, together with the VC, will often enter into an agreement to address means of preserving the unity and harmonious ownership and management of the Target. These issues include:

- The right of any holder to sell its securities and the rights of the other owners upon such sale to either purchase such securities or sell theirs at the same price.
- The right to buy back the founders' or key managers' holdings upon their departure from active roles in the Target (perhaps at a lower price and longer payment terms if the departure is for cause or the departure is voluntary but prior to a certain agreed-upon date).

- An agreement to elect various representatives of the VC and management personnel to the Target's board of directors.
- The right of a supermajority of directors, or of any one director (normally a VC director), to block the Target's taking certain enumerated actions, such as a sale, merger, or issuance of new stock).
- The preemptive right of security holders to subscribe to newly issued equity to avoid dilution.

§ 15:25 Other documentation

Other documentation typically found in a venture capital transaction includes:

- *Amendment to By-Laws.* Amendments may be required to be sure that the size of the Target's board of directors is sufficient to include representatives of the VC, the indemnification provisions are broad enough, the requisite committees of the Board have been formed, and the VC is able to call a special shareholders and directors meeting.
- *Employment Agreements.* It may be critical to the VC to assure that key executive employees of the Target are contractually committed and incentivized. Revised employment agreements are often delivered at closing of a VC investment.
- *Option Plan and Awards.* The adoption of an option plan for key executive employees or a grant of restricted equity to these employees is frequently a component of a VC transaction.
- *Confidentiality, Nondisclosure, Noncompete and Nonsolicitation Agreements.* These agreements are typically required of all, or almost all, employees of the Target on or before closing of a VC investment. The agreements serve to preserve the Target's valuable trade secrets and other intellectual property, protect against the raiding of current employees and customers, and restrain current employees from leaving the Target and competing with it.

VI. FUNDAMENTAL ISSUES

§ 15:26 In general

Many issues affecting the Target, founders, and VC arise

in structuring a venture capital transaction. While each transaction differs in its own unique respect, based on the nuances, economics, and personalities of each deal, certain themes recur. The following sections deal with issues commonly discussed and resolved prior to a venture capital transaction.

§ 15:27 Governance

Decision-making, whether on the day-to-day operations of the Target or fundamental issues, presents a frequent source of tension between VCs and founders. Control issues vary dramatically based on the size and stage of each investment.

Transaction documents typically define the size and composition of the Target's board of directors. The governing documents (typically the shareholders or operating agreement) will prescribe the number of directors and the right of a certain cross-segment of security holders or management team members to be represented on the board. For example, the board of directors may be comprised of five persons, with one selected by the VC, two by management, and one mutually agreed upon by management and the VC, with the fifth director being an industry expert.

While a VC may own a minority of the fully-diluted shares of the Target (i.e., after conversion of all convertible debt and preferred and options), it will nonetheless typically demand a far disproportionate influence in three respects:

- *Voting Power*. The VC's block of stock will usually possess the power to appoint at least one member to the Board. In addition, the VC director usually has the right to wield negative control in many major matters. For example, notwithstanding the fact that the VC may have a minority of the seats on the Board, major company actions such as the issuance of additional securities, sale or merger, or even hiring or firing of key personnel may require the VC director's assent. The scope of these rights is heavily negotiated. The parties will also negotiate the duration of the VC director's right. It may terminate after the next round of significant financing, the passage of time, or the reduction of the VC's ownership below a certain threshold.
- *Board Committees*. The VC may require the Target's board of directors to establish specific subcommittees for particular tasks and thereby enable the VC's direc-

tor to participate in greater degree in a more focused environment. These committees frequently address audit, compensation, and sometimes technology matters.

- *Information or Observer Rights.* Even if a representative of the VC no longer serves on the board of directors of the Target, the VC will often seek to gain access to information to which other shareholders may not be entitled. The VC may seek to observe or attend board meetings and be furnished the package of information provided to board members. The VC may also obtain the right to receive periodic financial reports and reports of the Target's activities.

§ 15:28 Governance—Pension plan investors

Public and private pension plans provide a considerable amount of the capital fueling VC funds. The fact that a VC fund has pension plan investors can influence the fund's desire to participate in the management of Targets in which it invests. If one or more pension plans have investments in a VC fund representing 25% or more of the fund's invested capital, the VC fund will be subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). If the VC investment is not structured correctly, the cumbersome provisions of ERISA will, for example, impose on the VC fund manager fiduciary duties to consider the impact of the VC fund investments on the beneficiaries and participants in pension plans and may expose the VC fund manager to liability if prudent investment and diversification standards are not met.

The harsh impact of having to comply with ERISA can be avoided if the VC fund is classified as an "operating company" under the plan asset regulations promulgated under ERISA. For these purposes, an operating company is defined as an entity that is primarily engaged, directly or through a majority-owned subsidiary or subsidiaries, in the production or sale of a product or service (other than the investment of capital). A venture capital operating company (VCOC) is treated as an operating company for ERISA purposes if: (a) at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are invested in operating companies in which the VCOC has management rights; and (b) the VCOC actu-

ally exercises such management rights with respect to one or more of the operating companies in which it invests.

For this purpose, "management rights" means "contractual rights directly between the VCOC and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company." The Plan Asset Regulations do not provide specific guidance regarding what rights will qualify as management rights, and the United States Department of Labor (DOL) has consistently taken the position that such determination can only be made in light of the surrounding facts and circumstances of each particular case, substantially limiting predictability in this area. The DOL has stated that management rights do not require that a VCOC have the power to direct a portfolio company's management to comply with the VCOC's input, and a VCOC may, for example, have management rights if it has appointed one director to a three (or more) person board. VCs typically receive a "management rights" letter at closing of the investment to document its right to exert such input, and this practice seems to pass DOL muster.

§ 15:29 Additional capital and dilution

Most growth stage companies continually need new capital to grow and VC-backed companies are no exception. Not until its later stages when its products are "cash cows" will a Target become fortunate enough to internally generate sufficient free cash flow to cover all operating and capital needs.

An often contentious issue in a VC financing transaction is how to protect the interests of the VC when the inevitable additional rounds of financing are required to soften if not eliminate the blow of "dilutive" financings. Since any sale of additional ownership interests reduces the existing investors' claims to the Target's assets and income stream, the broadest concept of dilution would render every financing dilutive. A more benign and practical view of dilution is to treat a financing as dilutive only if it negatively impacts on the measure of a business's value. If the value of the business is measured by earnings or book value, then financings reducing those elements are dilutive. For example, assume a business is valued by its owners' equity and that account is $1 million, with A and B owning 50% each. If C buys 25% of the common equity for $250,000, that purchase is dilutive to

the existing owners since $250,000 should have purchased only 20% of the business. If C buys 25% of the common equity for $333,333, that purchase is neither dilutive nor accretive to the existing owners. If C buys 25% of the common equity for $500,000, that purchase is accretive to the existing owners.

The following are various structures that can be used to reconcile a VC's desire to avoid dilution with the Target's need for financial flexibility.

1. Preemptive Rights. VCs invariably receive the right to purchase the number of shares or units necessary to maintain their percentage interests in the Target. While preemptive rights are nice to have in theory, in actuality the VC's appetite or capacity for additional investments may very well be satiated by the time additional equity is being raised. Preemptive rights typically terminate upon an IPO and sometimes terminate once the VC's ownership falls below a specified percentage or the VC fails to exercise them in one or more instances.

2. Full-Ratchet Method. The full-ratchet method is the harshest and most punitive VC protection against a "down round," or a new round of financing for the Target where the price per share sold in that round is less than the price per share purchased by the VC. The full-ratchet method reduces the VC's conversion price of its preferred stock from the purchase price paid by the VC to the purchase price paid by the new purchaser (or, if the VC has already converted its preferred, or has purchased common, the VC will be issued additional shares of common at that lower price).

For example, assume the VC purchased 100,000 shares of preferred stock convertible into common stock at $2 per share and new capital is raised by selling preferred stock convertible into common stock at $0.50 per share. Under the full-ratchet method, the VC's conversion price will be reduced to $0.50, and the VC thus will be entitled to convert its preferred stock into 400,000 shares instead of 100,000. This method has extremely harsh consequences to the founders since their shares are diluted not only by the down round but also by the change in the VC's conversion price. This dilution of the founders' interest is heightened especially if the amount raised in the down round was an insignificant amount of money.

Founders strenuously resist the full-ratchet method. It

implies that the founders are guaranteeing that the VC's stock will never go down in price and that the founders are to blame for any such decline. This logic may be appropriate in the rare case where the VC does not participate at all in decision making or on the board of directors of the Target, but in most cases the VC is active and also has the ability to veto the transactions causing significant price declines. Middle ground compromises include: adopting the full-ratchet method for the first 12 months and then use a fairer method thereafter, only employing the full ratchet method if the amount raised exceeds a specified level (to avoid the absurd result of lowering the VC's price when only $1,000 was raised in the down round), or using the full-ratchet method only if new financing is needed resulting from a breach of representations and warranties or covenants of the Target.

It is estimated that the full-ratchet method appeared in 2 to 3% of VC deals in the first half of 2011.

3. *Weighted-Average Method.* A fairer approach to protect the VC against dilution is the weighted-average method. This method also reduces the VC's conversion price to a lower number, but that lower number depends on the number and price of new shares issued in the subsequent offering.

For example, assume that a Target had 200,000 issued and outstanding shares (including the VC's 100,000 shares of convertible preferred and including 20,000 options and warrants to purchase common stock) prior to the new offering, and the VC's initial conversion price was $2 per share. If the Target issued 100,000 additional shares to a new investor at $0.50 per share raising $50,000 in new funds, the VC's conversion price would be reduced from $2 per share to $1.34 per share determined as follows:

New Conversion Price = ((X + Y) / (X + Z)) x Old Conversion Price

In this formula:

X is the number of issued and outstanding shares (including 20,000 options and warrants) before the new financing (i.e., 200,000);

Y is the number of shares that the new financing would

have purchased using the original higher conversion price (i.e., $50,000 would have purchased 1,000 shares at the original per share price of $2 per share); and

Z is the number of shares actually issued as a result of the new financing (i.e., 100,000).

This formula should only apply if subsequent rounds of financing are at lower prices, thus locking in their low price per share. Complications arise with warrants and options, as well as with subsequent rounds of financing with prices between the original and new price, or with options taken into account in computing X that are very far out of the money so as not likely to ever be exercised. Careful drafting should also exclude shares from X shares for a variety of factors including the impact of conversion of preferred shares, employee options upon conversion, and shares issued due to a merger or strategic alliance.

If X in the above formula includes all warrants and options (whether in or out of the money), it is known as the "broad-based" weighted-average formula. Since X will by definition be a larger number by virtue of including more shares, this formula will cause less dilution and therefore be favored by the founders and management.

The other weighted average formula is known as the "narrow-based" weighted- average formula. This formula excludes all options and warrants from X. In the above example, excluding 20,000 options and warrants would result in a new conversion price of $1.28 and thus cause more dilution than the broad-based approach. Due to the resulting lower conversion price than the $1.34 per share resulting from the broad-based weighted average formula, this approach therefore is preferred by the VC.

It is estimated that the broad-based method was overwhelmingly prevalent, appearing in 91% of VC deals in the first half of 2011 where the narrow-based method was used in 3 to 6%.

4. *Play or Pay Method.* Some founders detest the apparent unfairness of the VC receiving the downside adjustment of its conversion price with no risk or obligation to participate in subsequent rounds. The founder with significant bargain-

ing power may require the VC, therefore, to exercise its preemptive rights in order to avail itself of the dilution protection. Some "pay or play" provisions actually require the VC to convert its preferred shares to common at the higher original price if it refuses to participate in a new round of financing or at a minimum lose its preemptive rights or dilution protection in the future.

§ 15:30 Preferred equity

VC investments are virtually always made in the form of preferred equity (stock in a corporation or units in an LLC). Preferred equity comes in one of three basic forms. It may be "straight," where the preferred equity is tantamount to unsecured debt. On a liquidating event (like a control shifting merger, sale, or liquidation), sale proceeds are distributed to pay the preferred and are then distributed to the common holders. The only means for the VC to share in the upside generated from common holdings is to own a warrant to purchase common which could be exercised at closing.

A second form of preferred stock is convertible preferred. In this case, the VC chooses upon a liquidating event to either receive payment equal to the original price plus dividends or to convert its preferred to common. For example, if the VC purchases preferred equity for $1 million representing 10% of the Target's equity, the Target is sold for $9 million, and the accrued dividends are $100,000, the VC would elect to receive $1.1 million for its preferred stock instead of taking $900,000 (10% of $9 million) after converting the stock.

Finally, the preferred stock may be structured as "participating." In this case, the VC would receive a return of its investment (sometimes up to eight times!) and then convert to common. For example, assume that the VC's purchases preferred equity for $1 million representing 10% of the Target's equity, and the Target is sold for $20 million. The VC's participating preferred would entitle it to receive $2.9 million (i.e., the first $1 million as preferred and then 10% of the remaining $19 million representing its ownership of common). In this example, the VC in effect owns 14.5% of the fully-diluted common equity, not 10%.

Participating features frequently rankle. Founders typically argue that a participating preferred in effect treats the VC's investment akin to debt with a penny warrant for the

common. This is because the preferred gets paid off first, and then the VC shares in all additional upside. The founders would argue, therefore, that upon a liquidating event, the VC should either be required to convert its stock from preferred to common or simply be paid for its preferred equity investment. Given the assumptions in the example in the prior paragraph, the VC would receive $2 million (i.e., 10% of the $20 million sale price), not $2.9 million.

VCs would respond that, especially in the earliest rounds, little real value or funds have been committed by the founders so treating the VC investment like debt is eminently fair.

After a lot of discussion, the parties sometimes reach a compromise, which allows the VC to participate somewhat and then either be capped (like true preferred) or lose the participating feature.

Adopting participating or straight preferred varies with the economy and parties' negotiating leverage. As investments in Targets were in fair demand in 2010, the straight preferred approach was used in approximately 49% of VC deals. As the demand for Target investments intensified in the first half of 2011, straight-preferred structures increased to 60%. It remains to be seen whether perceptions of an imminent recession or low growth economy will shift the structures back in favor of the VC and its desire for participating preferred features.

§ 15:31 Preferred equity—Cap approach

A cap on the participating preferred feature is a device to reconcile some of the tensions discussed in the prior section. This compromise permits the preferred to participate until the VC earns a certain multiple of its investment (e.g. three to five times) or a certain internal rate of return (30 to 50%).

For example, assume that a VC purchases preferred stock convertible into 10% of the Target's stock for $1 million and has a participation right capped at three times its original investment. If the Target is sold for $21 million and there are no accrued dividends, the VC will receive $3 million ($1 million as a return on its investment in preferred stock plus 10% of the remaining $20 million). The $3 million cap does not come into play because the VC does not receive more than that amount.

A cap approach reduces the dilutive impact on the found-

ers and other holders of common stock and conversely reduces the return the VC would have had if the cap had not existed. But at some point, it causes the VC to become indifferent about whether the sales price of the Target or the amount received upon some other liquidating event is increased because the amount of the net proceeds received by the VC will not increase.

If the sales price in the preceding example was $25 million, the VC would still receive $3 million. Without the cap, the amount would be $3.4 million ($1 million as a return on its investment in preferred stock plus 10% of the remaining $24 million), but the maximum that can be earned with the cap is three times the VC's initial investment.

The zone of indifference for a particular series of preferred stock subject to a cap is calculated as the difference between X and Y, where X is the value at which the as-converted percentage of the total purchase price equals the cap and Y is the value at which the VC's allocation of the total purchase price calculated on a participating basis equals the cap. Solving for the values of X and Y that satisfy this relationship reduces to the following formulae:

X = Cap / As-Converted Percentage Represented by the Preferred Stock

Y = [(Cap — Liquidation Preference Amount) + (As-Converted Percentage Represented by the Preferred Stock x Liquidation Preference Amount.)] / As-Converted Percentage Represented by the Preferred Stock

If a VC purchases preferred equity for $1 million representing 10% of the Target's equity and the participating feature is capped at three times that investment, the zone of indifference is $9 million computed as follows:

X = $3 million / 10% = $30 million

Y = [$3 million — $1 million + (10% x $1,000,000)] / 10% = $21 million

$$X - Y = \$9 \text{ million}$$

This means that the VC receives the same amount on a sale of between $21 million and $30 million. If the price increases to $31, the VC's share of the proceeds increases to $3.1 million, which is the VC's 10% share if all of its preferred stock is converted to common.

§ 15:32 Preferred equity—Caps and conflicts of interest

As described above, a cap on participating preferred can create a wide range of acquisition prices over which the VC is indifferent. While the purpose of the cap is to minimize the dilutive impact on common stockholders that would otherwise result from uncapped participating preferred, the cap has the unintended consequence of creating this "zone of indifference." It is important for stakeholders—members of the board of directors, founders, common stockholders, and preferred stockholders alike—to understand this zone of indifference and the impact it may have on decision-making dynamics of shareholders when presented with an offer to be acquired. It would be reasonable to assume that a VC investor might be less inclined to push a negotiation with a potential acquirer with the same zeal as founders and other common stockholders in order to extract a value greater than the cap.

The existence of a zone of indifference could potentially lead to a breach of the duty of loyalty of a director of the Target who represents the interests of preferred shareholders. A recent Delaware Chancery Court decision, *In re Trados Inc. Shareholder Litigation*,[1] alarmingly illustrated this dilemma. In that case, the directors, a majority of whom the preferred stockholders designated, approved a change of control transaction where all of the merger consideration was shared between the preferred stockholders on account of their liquidation preference and the management team under a management compensation program. Given the price, the common stockholders received nothing. The common stockholders then sued the board al-

[Section 15:32]

[1]In re Trados Inc. Shareholder Litigation, 2009 WL 2225958 (Del. Ch. 2009).

leging that the directors breached their fiduciary duties since the common stockholders received no merger consideration, alleging that if the board had not approved a sale of the company and it continued to carry out its business plan, the company would have appreciated in value in the future and the common shares would have ultimately become "in the money." This decision, the plaintiffs contended, resulted from the preferred directors' conflicting loyalties between the preferred and common stockholders. The court denied the preferred director defendants' motion to dismiss the suit and held that the presumption in favor of the business judgment of the preferred directors had been successfully rebutted given this conflict.

A few careful steps could have enabled the preferred directors to avoid this liability. First, the acquisition documents failed to contain any drag-along provisions which would have obviated any board action.[2] Second, the business was a Delaware corporation where the state corporate statute and case law impose various fiduciary duties on directors. If the Target had been a limited liability company, its operating agreement could have disclaimed or limited these types of duties and insulated the directors from this exposure (although this form could have possibly different and inefficient tax results depending on the nature and form of ultimate exit). Third, the directors should have evaluated the breadth and scope of applicable contractual indemnity agreements with the company and corollary charter provisions. Director and officer insurance policies are also an obvious means to reduce, if not eliminate, the economic exposure of liability if not the mere existence of litigation. Fourth, the directors did not develop a careful record of the degree of deliberation and sensitivity which they may have given to the needs of the common stockholders. The court inferred that a better record might have reached the legal conclusion that the directors discharged the appropriate quantum of care. It is possible that the trier of fact will ultimately reach this conclusion, many years and countless dollars later.

§ 15:33 Preferred equity—Liquidation preference

A corollary of the participating feature of a VC's preferred stock is the liquidation preference a holder receives over

[2]For a discussion of drag-along rights, see § 15:36.

holders of other series of preferred stock and over holders of common stock. Until the proverbial bubble of venture capital financing burst in the early 2000s, new preferred stock typically was either subordinate in liquidation preference to, or shared a liquidation preference with, earlier series of preferred stock. For example, if series A preferred investors first invested $100X and then series B preferred investors invested $200X and the Target was ultimately liquidated for $100X, the series A investors would either receive the entire $100X or one-third of the $100X with two-thirds going to the series B investors (since they furnished two-thirds of the total capital). In most modern venture capital financings, however, new money (the series B investors in this example) receives liquidation preference over the earlier rounds of preferred equity. Thus, if the Target was liquidated for $100X, the series B investors would receive the entire proceeds and the series A investors would receive nothing.

§ 15:34 Exit strategies

The VC's attitude regarding the ultimate disposition of its investment varies based on the nature and risk tolerance of the VC. Most VCs have fund documents which impose a finite life of the fund, typically seven to 10 years, in which they expect their investment to remain outstanding before it is monetized.[1] This relatively-short time horizon is dictated by several factors. One of the primary factors is that investors in VC funds demand a payback in a relatively short period of time, and therefore the VC is merely expressing the needs and demands of its clientele.

Many institutional investors may tolerate a longer holding period based on the nature and quality of the investment. Pension funds and insurance companies, whose obligations to beneficiaries extend for decades in the future justify holding an asset like a stock that far in the future. But insurance companies, as taxpaying entities unlike pension funds, have to be concerned with paying significant capital gains taxes on long-term holdings. The implied tax liability to Berkshire Hathaway, for example, based on its current gains in Coca-Cola, Gillette, Washington Post, and Disney is in the billions of dollars.

[Section 15:34]

[1]National Venture Capital Association, Frequently Asked Questions, available at http://www.nvca.org/faqs.html.

A blueprint to ultimately dispose of the investment, therefore, is a major priority of a VC and is a prominent topic during the negotiations. The blueprint for the VC's ultimate exit may take several forms, as is discussed in the following sections.

§ 15:35 Exit strategies—General transfer restrictions

VCs want to assure that the founders will not be able to freely sell their shares in the Target. If the founders are financially "joined at the hip" with the VC that has invested in the Target, they will stay focused and motivated. The founders may agree to these restrictions for a certain period of time (three to five years), but after that time elapses will want to be permitted to sell to any third party. VCs may not want any restrictions on their own ability to sell any shares at any time but may have to agree not to sell their shares for the same reasons they wish to prevent the founders from selling the founders' shares. The parties may also permit each owner to sell a de minimis amount of stock for liquidity and estate planning purposes.

Transfer restrictions ordinarily provide that any sale may be subject to the applicability of the securities laws restrictions on the sale of unregistered securities. Sales may also be subject to drag-along or tag-along rights or rights of first refusal, offer, or negotiation.

§ 15:36 Exit strategies—Drag-along and tag-along rights

After the expiration of any holding period that prohibits any or all owners from transferring its shares for a period of time, the VC may desire to sell its shares to third parties. Since the VC does not own all of the Target's shares, the VC's efforts to sell the Target may be thwarted if the third-party buyer desires to purchase all of the Target stock. Therefore, VCs who own a majority of the shares of the Target typically require the right to cause the founders' shares to be dragged along and sold to the buyer at the same price if either the buyer requests or the VC believes that the sale of all of the stock will enhance the prospects for sale of the Target. Founders may oppose the VC's right to sell their shares at any time and attempt to place some time, and perhaps performance, limitations. Otherwise, a VC may choose to sell its shares simply as an escape mechanism,

oblivious to the founders' years of effort and belief in the viability of the Target. Drag-along rights are rarely, if ever, granted to founders.

The founders may also have concerns about the VC's sale of its shares of the Target. While the founders or the Target may extract a right to first refusal, offer, or negotiation relating to such a sale, the founders may feel that their ability to purchase a VC's shares is illusory since the founders do not have a realistic access to capital to acquire the share. The VC's reply is that this inability should not preclude its opportunity to sell and should not harm the founders, since in substance one investor is merely being replaced by another. Whether this view is true depends in part on the degree the selling VC participates in or actually controls the Target.

To resolve the founders' concerns, the founders may be given tag-along or piggyback rights enabling them to sell their shares at the same time and price as the VC's shares. Giving the founders tag-along rights may be acceptable to the VC if the rights are ineffective if the buyer genuinely would not buy the Target unless the founders maintain their same ownership interest and therefore have the same motivation inherent in ownership of a business. This concern is only rarely voiced by buyers, and many avenues pave the way to address this concern, including selling some of the founders' stock and rolling the balance over on a tax deferred basis into the buyer's entity, giving options to founders to buy stock in the buyer company, or selling the founders some stock in the buyer company.

◆ **Practice Tips:** In drafting tag-along clauses, consideration needs to be given to how they will operate if less than all of the stock of the Target is to be sold. If a tag-along clause simply allows the founders to sell their stock on the same basis as the VC, the clause leaves unanswered the question of what happens if the buyer wants to purchase 80% of the stock of the Target and the VC owns 80% of those shares. If the buyer is unwilling to purchase more than 80% of the stock, the tag along may mean that the VC may now only sell 80% of its shares (64% of the Target's total outstanding shares) and the founders may also sell 80% of their shares (16% of the Target's total shares) to give the buyer the desired 80% of the total stock in the Target.

In drafting tag- along and drag-along clauses, the

impact of participation rights is critical. If the selling price is $100X and the VC's preferred is valued at $100X, then it is inaccurate to say that all holders will receive the same price, terms, and conditions. The documents will need to specify that the holder's entitlement to these items is subject to liquidation and similar preferences.

§ 15:37 Exit strategies—Right to cause a sale

A common, but hotly contested, exit strategy affords the VC the right to cause the business to be sold or merged. VCs that own a majority or close to a majority of the shares of the Target typically demand this right, which they can exercise at any time. The parties may agree that some time should elapse before this right could be triggered in order to give the founders a chance to implement the business plan. In lieu of tying the right to cause a sale to a specific time period, some arrangements require the occurrence of some event such as a deadlock on major issues, failure to achieve targeted financial goals, or the departure of a key founder. Sometimes, the parties agree to give either party the right to sell the business at any time, or after a certain time, for a price not less than an appraised or agreed to minimum value. The other party would then have the right to match that price prior to the time the business is marketed for sale.

While some VCs may desire the flexibility to be able to cause a sale of the stock or assets of the business at any time, the founders will want to limit the periods during which the business is being shopped. This reduces the negative impact on employee morale and customer confidence that naturally occurs during the sale period. Whether this type of right will be conferred on a VCs will also vary with the ownership level and whether certain performance milestones were required to be met.

§ 15:38 Exit strategies—Rights of first refusal, offer and negotiation

To achieve the goal of maintaining continuity of ownership, each shareholder frequently gives the right of first refusal to the other shareholders prior to the sale of the shareholder's stock. This right allows the non-selling shareholders to match a bona fide arm's length offer made by a third party. Since the offer is from an unrelated third party, it is thought to be for a fair price. If the selling

shareholder is offering an unreasonably low price to the third party due to the seller's personal circumstances necessitating the sale, the other shareholders can reap this benefit. If the price the third party is willing to pay is very high, the non-selling shareholders are not required to exercise their first refusal right. Indeed, the other shareholders may be able to avail themselves of a tag-along right, or, in some circumstances, cause the conversion of the selling shareholder's interest to nonvoting stock.

Many, particularly VC funds, object to the concept of a right of first refusal on the grounds that it may have a chilling effect on would-be purchasers. The third party purchaser's enthusiasm is repressed by in effect not knowing whether its deal will be consummated. Third-party purchasers also resist acting as the stalking horse to set the price that someone else can match.

Founders will counter that each VC fund is unique and the founders should have the right to decide with whom to do business.

To address the concern that rights of first refusal may have the practical impact of reducing the universe and attractiveness of potential purchasers of privately held stock, some shareholder agreements provide for rights of first offer and first negotiation. A right of first offer essentially requires the selling shareholder to first make an offer to the non-selling shareholders at a price the selling shareholder would be willing to sell its shares. If the non-selling shareholders do not wish to purchase the shares at this price, then the selling shareholder has a finite period of time to market the shares for a price equal to or above the offered price. This approach enables the non-selling shareholders to assure that the price is fair by giving them an opportunity to participate in the purchase. It also allows the selling shareholder to pursue the sale without the specter that a would-be purchaser will be discouraged by the existence of the right of first refusal.

The time period during which the shares must be sold at or above the offered price should be kept relatively short (e.g., not more than six months). This minimizes the psychological and logistical impact of having the business or large block of stock being perpetually up for sale.

The right of first offer should also adjust for the circumstance where the price is ultimately reduced below the offer

price (e.g., due to a purchase price adjustment between signing and closing caused by losses or declining levels of working capital). A modest, let's say 5%, reduction below the offer price is generally accepted as reflecting the realities that the business can deteriorate by some amount without starting the entire right of first offer process over again from scratch.

Some VCs believe that a right of first offer also has a chilling effect on would-be purchasers due to the many timing and price caveats contained in first offer provisions. For example, the possibility that the value of the business may decline and thus reduce the sale price below the offer price, or the closing may be delayed due to financing or regulatory reasons and, therefore, the process must be recommenced, may serve to dissuade many possible purchasers from trying to buy the shares. Therefore, some agreements only require the parties to negotiate in good faith for a finite period. If this right of first negotiation does not result in a binding agreement within a finite period, then the selling shareholder is free to sell for any price, even a price below the previous negotiated price. This approach provides the selling shareholder with the most certainty that its sales efforts will not be impeded by the other shareholders' rights. Considerable subjectivity, however, regarding the standards of good faith negotiation abounds, and the threat of litigation over this issue could loom large. The ability to negotiate in good faith with parties with whom distrust or antagonism may be present is also difficult.

§ 15:39 Exit strategies—Put and call rights

A VC may seek rights to require the Target to purchase its shares, or a put, as an exit strategy. The put may be triggered by the lapse of time, the occurrence of deadlock, a material breach of the representations and warranties in the stock purchase agreement, the departure of key founders, or a failure to meet specified financial targets or other targets such as obtaining a patent or getting a product commercialized. The put price might be either the liquidation value of the VC's preferred equity (i.e., the amount paid for the preferred less any returns of capital plus all accrued dividends) or some formula or appraised value for the common equity. While a formula value is sometimes used (e.g., a multiple of cash flow, revenues, or net earnings), this method can be dangerous since fair and appropriate formulas vary over time and the current risk profile and stage of the business.

A put right is also of questionable value in a real practical sense. If the Target is doing well, the VC has other means available to it to liquefy its position. If the business is doing poorly, the Target may not have a means of financing the put, and therefore, the impact of the put is to convert the VC's equity to the right of an unsecured creditor.

Some Targets will extract a right to purchase, or a call, from the VC as the logical mirror of a put. The pricing and terms of the call may be the same as the put, except the call right is usually delayed for a year or two after the time that the VC is first able to exercise the put.

The value of a put right may be discounted by a small percentage, say 5%, as the price the VC is willing to accept to convert its investment to cash. Conversely, a call right may carry a 5% premium (or perhaps a premium which declines over time) to compensate the VC for having its interest redeemed involuntarily.

VCs resist call rights since they cap price appreciation and may be exercised prior to a significant monetizing event such as a sale or IPO. The Target may retort that the call is a last resort and may only be exercised after the VC has had the right to put the stock. Further, the VC can in effect negate or soften the impact of the call by converting its preferred stock to common. The call treats the VC fairly, moreover, since the price of the preferred stock is fixed and the value of the common stock will be fair market value.

Founders may also ask for puts (and expect calls) in some circumstances. Death, disability, and termination of a founder's employment with the Target without cause are frequent triggering events. In the event that a founder is terminated without cause, the founder may also seek a right to revalue the put or call price if the Target is sold for a higher price within a one to two-year period. This revaluation right keeps the Target honest and prevents it from terminating the founder prior to a contemplated sale. Many agreements, however, do not provide for any such put or call upon the founders' departure. Instead, the founder will simply retain the vested portion of his or her equity and go along for the proverbial ride.

Finally, payment terms for the puts and calls need to be set by advance agreement. If the Target cannot afford, or does not desire, to use cash, it frequently has the alternative to defer payment. The payment period for repayment is usu-

ally two to three years shorter with a call (since the company initiated the call) than with a put. The interest rate may also be higher with a call than a put. Granting security to the redeemed shareholder, except for a security interest in the shares being repurchased, is rare. Limiting payments under a put to some percentage of the company's net cash flow should also be considered to assure that the business can still operate and will not be unnecessarily burdened by the put or call. Finally, acceleration in a sale or change of control should be expected.

§ 15:40 Exit strategies—Registration rights

A VC's final, and often ultimate, exit strategy is the right to demand that the Target register the VC's shares on the public market. These registration rights will be documented in a hotly contested registration rights agreement. Ironically, these agreements are usually either negotiated with the fictional and absent future underwriter in mind or actually subsequently changed by the underwriter who has a substantial role in determining the marketability of the shares.

VCs desire the right to demand registration of their shares at any time, regardless of whether the business is then public or is planning an IPO. Like the right to sell the business at any time, VCs feel they need this flexibility to ultimately monetize their investment independent of the Target's perhaps countervailing wishes. The founders typically respond that the ability to demand registration at any time under any conditions gives too much power to the VC and evinces little support and conviction in the investment. At the first sign that the business is doing well, the VC could exit. Further, the right to demand registration prior to the Target's IPO sends a message to the marketplace that the sophisticated investor group smells trouble and wants out, thus imperiling the ultimate IPO. Finally, being a public company fundamentally changes the Target, in terms of its operations, potential liability, and reporting relationships. Some founders weigh these many inconveniences more strongly than some of the positive aspects of going public and want to participate in such a dramatic decision.

§ 15:41 Exit strategies—Registration rights—Pre-IPO

Many compromise positions reconcile the parties' conflict-

ing goals. A common approach affords a VC or group of VCs the right to demand public registration of the Target's shares, even before an IPO, if certain conditions are met. A certain percentage, usually 50% to 75%, of the Target's shareholders must join in the demand. This assures solidarity of the VC group for this major event. The amount that the underwriters believe will likely be raised must exceed a threshold, typically $20 million to $50 million.

As a trade-off for the right to cause a sale of the Target's shares under an IPO, the VCs are required to accept underwriter marketing restrictions on the time and manner of sale of the shares. These underwriter cutbacks and lockups defer to the underwriter's purported superior knowledge of the marketplace and its view regarding the best way to price and market the shares. Underwriters frequently restrict, if not eliminate, the right of the VCs and founders to sell on the IPO and for a finite period, typically 90 to 180 days after the IPO. Underwriters believe these restrictions show confidence in the company to the marketplace. The restrictions further prevent an overhang of supply of shares desired to be sold, which supply will depress the share price. Further, if the underwriter does permit VCs and founders to sell some of their stock on the IPO (which rarely occurs), the underwriter may reduce or cut back the number of shares permitted to be sold if market conditions so dictate.

If VCs are not given the right to require an IPO upon meeting certain market conditions, then they will attempt to receive a right to demand an IPO after the passage of a certain amount of time. If the Target has not registered for an IPO within three to five years, then a VC will sometimes want the right, notwithstanding any dollar or size restrictions, to market the Target or its shares by way of an IPO. While this right sounds helpful, it too may be hollow. If the Target is doing well, it may have already gone public or be generating sufficient cash flow to buy back the VC's shares. If the Target is not doing well, the ability to dump its shares on an unwitting public is doubtful. Granting such a right, furthermore, allows one shareholder or group of shareholders to cause the Target to fundamentally change its nature and character from a private to a public company.

§ 15:42 Exit strategies—Registration rights—Post-IPO

If the Target's shares are already public, the VC may have

anywhere from one to an unlimited number of demand registration rights, subject to a multitude of restrictions. The VC and founders will, absent an agreement to the contrary, be able to sell their shares, even if they are not registered, under Rule 144.[1] They may also be able to sell the shares through a private offering under an exemption from registration under Regulation D.[2]

The Rule 144 safe harbor specifies the manner in which unregistered ("restricted") shares held by VCs and founders may be sold in the open market after the Target makes a public offering. Differing rules apply depending on whether the holder is an "affiliate" of the Target. If a VC or founder is not an affiliate of the Target (i.e., if the VC or founder is no longer directly or indirectly a director, key employee, or owner of in excess of 10% of the voting stock of the Target) and has not been an affiliate for a period of three months, the VC or founder's shares may be sold to the public without any restriction after six months if the Target is subject to the reporting requirements of the Securities Exchange Act of 1934, or after one year if the Target is not subject to the reporting requirements. If the VC or founder is an affiliate, it may sell shares after the time periods described in the preceding provisions in "dribble out" amounts in broker transactions. These dribble out rules limit the number of shares that can be sold, in any three-month period, to the greater of 1% of the Target's outstanding shares or the average weekly reported trading volume for the four calendar weeks preceding the filing of the required notice of sale. The dribble-out restrictions are removed after a shareholder ceases to be an affiliate for a three-month period and the shareholder has held the shares for a six-month or one-year period, depending on whether the Target is subject to the reporting requirements of the Securities Exchange Act of 1934.

If the VC or founder is an affiliate and desires to sell shares, it must file a notice with the SEC on Form 144 if the sale involves more than 5,000 shares or the aggregate dollar amount is greater than $50,000 in any three-month period.

[Section 15:42]

[1] 17 C.F.R. § 230.144.

[2] 17 C.F.R. §§ 230.501 to 230.508.

For a discussion of Regulation D, see §§ 17:9 to 17:20.

The sale must take place within three months of filing the form, and if the securities have not been sold, an amended notice must be filed.

Some registration rights agreements also require Target to file a "shelf registration" at its expense and to keep the registration statement effective for nine or more months. This shelf registration process is not expensive and provides owners of restricted unregistered shares the right to sell the rest of their shares in a straightforward manner, without the Rule 144 restrictions.

§ 15:43 Exit strategies—Registration rights—Delay of registration

Demand registration rights may be restricted further by the Target in certain circumstances. To comply with securities law requirements regarding full disclosure of material events, the board of directors of the Target may have the right, if not the obligation, to delay the exercise of any demand right if the Target is undergoing material events. For example, if the Target is in the middle of a significant acquisition negotiation, or is suffering a financially troubling quarter, the board may believe that the disclosure required by a public offering or a subsequent public offering (a "secondary offering") may hurt the Target's business and stock price. The board's ability to delay exercise of these rights is typically limited to a 90 to 120 day period and no more than one or two such periods during any one year.

§ 15:44 Exit strategies—Registration rights—Piggyback rights

Once the Target is public, the VC and founders are typically afforded an unlimited number of rights to sell shares at a time when the Target is engaging in an additional sale of its shares. These "piggyback" registration rights are also subject to underwriter cutbacks and lockups. They also typically prioritize the relative rights of the shareholders who are availing themselves of the piggyback right. For example, if the Target desires to sell one million shares, the VCs desire to sell 500,000 shares, the founders desire to sell one million shares, and the underwriter determines that market conditions will only permit the sale of 1.5 million shares, the piggyback provisions will usually allow the Target to sell all one million of its desired shares and then the remaining

500,000 may be allocated two-thirds to the VC and one-third to the founders. Some piggyback clauses provide that the party whose desired sale of shares is being reduced cannot be cut back any more than 70% of its desired number, so at least they are assured that some of their shares could be sold.

§ 15:45 Exit strategies—Registration rights—Expenses

Although the Target may require the requesting party to pay for registration expenses, the Target usually bears most of the costs of registration rights. The legal, accounting, brokers, underwriting discounts, blue sky registration, printing, and other related costs is therefore absorbed by the Target notwithstanding its mere acquiescence with the IPO or secondary offering. The cost of counsel for the selling shareholders is typically limited to the cost of one counsel selected for the entire group. The cost of any disclosure relating to a particular selling shareholder is usually borne by that shareholder. If the Target needs to do a complete new audit since its last audit is not sufficiently current (i.e., it should not exceed more than 134 days old), that cost may be borne by the requesting shareholders. Sales commissions and other expenses unique to a selling shareholder are paid by that shareholder. The selling shareholder will also pay for, and indemnify the Target for, any misrepresentations made by that shareholder regarding the shares or the Target.

§ 15:46 Compensation of VC fund managers

VC funds are typically managed by professional VCs ("GPs"). GPs are typically compensated in two ways. First, they receive a management fee of between 1 and 2% of the committed capital of the fund during the first four to five years of the fund life. Thereafter, the fee is computed based on the actual unreturned capital contributions of fund investors. Second, the GP receives a portion of the profits made by the VC fund—commonly called a "carried interest." The value of a carried interest is unknown at the time it is created because it depends on future profits, so the tax on the carried interest is postponed until the fund realizes profits by selling or otherwise monetizing its investments. The profits are taxed as long-term capital gains if they are realized on investments held for more than one year.

Over the past few years, there has been heated discussion of a change in the taxation of carried interests to treat them as ordinary income. So far, the treatment as capital gains has been retained. Venture capitalists argue that the current framework represents an incentive for them to invest in America's most promising companies and continue to fuel the U.S. economy. VCs only realize a return on their investment if the company goes public or is merged or purchased by another company. This type of investing is high-risk and it is estimated that about 40% of venture-backed companies fail, 40% return moderate amounts of capital, and only 20% produce high returns. Others argue that this form of compensation is tantamount to a bonus or unexercised stock options which should be taxed at ordinary income rates.

VII. CHOICE OF ENTITY AND FEDERAL TAX CONSIDERATIONS

§ 15:47 In general

The Target will typically be organized as a corporation (typically under the tax regime of Subchapter C of the Internal Revenue Code) or a limited liability company. In the early stage, Target may be organized as an LLC to achieve pass-through of losses to its owners and tax any distributions only once and not twice as they would be in a C corporation. However, countervailing considerations often favor the Target to take C corporation, rather than LLC, form as discussed below.

§ 15:48 Limitations of S corporations

Although the S corporation form will also permit losses and deductions to pass through to the Target's owners and there is only one layer of taxation on most distributions, such pass-through treatment is achieved with limitations as to the number and types of owners of the Target. More importantly however, the S corporation form only permits only one class of equity. This limitation is critical since, as discussed above, most VC transactions involve one or more classes of preferred stock. Therefore an S corporation is never used in VC transactions since VC funds are not qualified S corporation stockholders and the type of issued security to most VCs is incompatible with classification as an S corporation.

§ 15:49 Unrelated business taxable income

A difficulty in attracting VC capital investment to a Target organized as an LLC is created where investors in the VC fund include qualified benefit plans and other tax exempt investors. The distributive share items flowing from an LLC to retirement plan investors will likely give rise to unrelated business taxable income thereby subjecting the otherwise tax-exempt investor to current taxation on such earnings. While the VC fund can set up a blocker corporation to trap this unrelated business taxable income, many funds prefer not to undertake this expense and administrative inconvenience.

§ 15:50 Exit strategy and acquisitive reorganization transactions

A well-counseled Target will choose its form in part on its likely exit strategy. While no one has a crystal ball regarding the type of ultimate disposition, if there is a high probability that the Target's exit will be a sale to a public company for a purchase price which includes a large portion of equity in the buyer, the Target should move to be in corporate form well in advance of such acquisition transaction. The tax-free reorganization provisions of I.R.C. § 368 provide rules for the nontaxable receipt of acquirer stock when the Target is in corporate form. The favorable provisions of that Code section do not apply to LLCs, as they are typically treated as partnerships for tax purposes.[1] If the Target is an LLC, it may not be able to time its conversion to corporate form in a way to be sure that the conversion will not be considered a subterfuge by the IRS or the conversion will not trigger an income tax on the appreciation of the Target's assets.

§ 15:51 Qualified small business stock

Other benefits of choosing a C corporation form for a Target are found in I.R.C. §§ 1202 and 1045, which are designed to encourage investments in start-up companies. Section 1202 excludes 50% of the gain realized on the dispo-

[Section 15:50]

[1]For a discussion of the tax-free reorganization provisions of the Code, see §§ 26:1 et seq.

sition of qualified small business stock from the taxable gain of non-corporate taxpayers if the stock has been held for more than five years. Qualified small business stock is stock in a C corporation that is originally issued after August 10, 1993, and is acquired by the taxpayer in exchange for money, property, or as compensation for services. The corporation may not have gross assets in excess of $50 million in fair market value at the time the stock is issued.

Gains on qualified small business stock held for at least one year are taxed at a rate of 28% under current law, so the effective maximum tax rate on the total gain after the exclusion is 14%. This not substantially less than the 15% maximum tax rate that applies to most capital gains of individuals and other non-corporate taxpayers and therefore not likely to be a major factor.

However, the American Recovery and Reinvestment Act of 2009 increases the exclusion of a capital gains from sales of qualified small business stock to 75% for stock acquired between February 13, 2009, and September 27, 2011. This reduces the effective maximum tax rate to 7%.

The Creating Small Business Jobs Act of 2010 excludes 100% of the capital gains from sales of qualified small business stock acquired between September 28, 2011, and December 31, 2011, reducing the effective tax rate to 0%.

Under I.R.C. § 1045, if a non-corporate taxpayer holds qualified small business stock for more than six months before its sale and uses the sale proceeds to purchase other qualified small business stock within 60 days after the sale, the entire gain can be rolled over tax free into the replacement stock. There is no gain recognized on the sale of the original qualified small business stock. However, the taxpayer's basis in that stock becomes the basis of the new stock, so the recognition of gain is simply deferred until the new stock is sold.

VIII. FEDERAL INCOME TAXATION F EQUITY-BASED COMPENSATION ARRANGEMENTS

§ 15:52 In general

Attracting, motivating and retaining key executive talent is a major goal of any Target, no matter how well established or nascent. While this chapter is not focused on tax issues, the following sections set forth basic equity based compensation principles. In many VC-backed companies, employees

receive less base compensation in exchange for the promise of a big payday in the future, represented by appreciation in the value of the company. The challenge described in this and the remaining sections of this chapter are to do so in a tax efficient manner aligning the goals of cash investors and those providing sweat equity.

§ 15:53 Restricted stock

Sometimes, key management personnel are granted stock, typically common stock, in exchange for their management services. If the ownership of the stock is subject to a substantial risk of forfeiture or other restrictions, then the executive will owe no income tax until such restrictions substantially lapse. Upon the lapsing of the restrictions, however, the executive will owe income tax, at ordinary income tax rates, on the then fair market value of the stock in excess of its basis. While appropriate discounting (for minority interests, illiquidity, and perhaps subordination of common stock to other layers of preferred stock) may reduce the value of the stock and therefore reduce the income recognizable by the executive, nonetheless substantial appreciation may have occurred from the date of original grant. Once the executive pays the income tax on the receipt of the stock, any future appreciation would be taxed at long term capital gains rates, assuming the requisite one-year holding period is met.[1] It is also possible that the gain will be subject to the favorable tax treatment accorded qualified small business stock.[2]

To avoid a potentially large income tax obligation at ordinary income tax rates, and to convert future appreciation from ordinary to capital gains rates, executives are often encouraged to make an election under I.R.C. § 83(b) at the time of receipt of the stock. This election, which must be made within 30 days of receipt of the stock, allows the executive to pay income tax at ordinary income tax rates on the fair market value of the stock (again, with appropriate discounts) upon receipt. Any future appreciation is therefore taxed at long term capital gain rates (assuming the one-year holding period is met).

[Section 15:53]

[1]For a discussion of grants of restricted stock, see §§ 38:25 to 38:28.

[2]See § 15:51.

The I.R.C. § 83(b) election, and consequent acceleration of the tax obligation, is particularly sensible in the context of an early stage business when the value of the stock is believed to be low and therefore any income tax would be low or non-existent. In a later stage business, the executive simply may not have the cash to pay the taxes no matter how beneficial the acceleration of this tax (and concomitant conversion of future appreciation from ordinary to capital gains rates). In such event, alternative compensation strategies involving stock options should be explored. Alternatively, the VC or the Target could loan the executive the funds to pay the tax. The terms of repayment can be generous, with low interest and little if any amortization until a change of control or executive departure from the Target, although this can cause the Target to recognize imputed interest income under I.R.C. § 7872.[3]

Even if stock is granted outright, the Target may reserve the right to repurchase the stock at cost for a period of time. This, in effect, mirrors the vesting of stock options discussed in subsequent sections.[4] and, in effect, serves to assure that the executive remains with the Target for a certain period of time. A repurchase right is a substantial risk of forfeiture and results in the value of the stock being treated as compensation to the employee only when it lapses.

§ 15:54 Sale of stock

The Target may also consider selling stock outright to executives. Many believe that outright ownership which requires an executive to write a check better aligns the interests of management and the VC investors as they both have proverbial "skin in the game." As in the case of the grant of stock, the sale of stock provides enormous tax advantages to the executive since it allows the executive to pay tax on any future gain at the capital gain rates and, if applicable, perhaps the even the lower rate for a qualified small business.

Sometimes, the Target or VCs will loan money to the management team to purchase the stock. If the terms are

[3]For a discussion of the taxation of loans by corporations to shareholders, see § 25:24.

[4]See §§ 15:55 to 15:57.

generous, the Target may have imputed interest income.[1] If the loan is nonrecourse to the executive and recourse solely to the shares, the loan will be viewed as income to the executive since there is no meaningful personal obligation to repay.

If the sales price for the stock is below fair market value (however determined), the bargain element will result in a current income tax to the executive. The sale could be financed through a loan from the Target or VCs.

§ 15:55 Stock options

The most prevalent form of incentive compensation plan in VC-backed companies is an equity option plan. Options provide the executive the right to buy a finite amount of shares of the stock of the Target at a specific price for a specific time. Options provide executives with the best of both worlds. If the stock appreciates, they will presumably exercise some day and pocket the difference between the sale price and exercise price. If the stock value declines, they will not exercise in most circumstances and therefore risk nothing, except the opportunity to have worked at another VC-backed company whose stock may have appreciated.[1]

Stock options are typically subject to vesting rules that attempt vesting requirements and other forfeiture provisions to attempt to assure that the recipient grantee remains with the Target for some period of time. Under vesting rules, the executive's right to the full value of the options is staggered and comes into effect only if he or she remains with the company.

Stock option plans come in two varieties, and the distinctions between the two revolve largely around the income tax and accounting treatments. The two basic types of stock option plans are statutory or qualified option plans, sometimes called incentive stock options ("ISOs") and non-statutory or nonqualified options.

§ 15:56 Stock options—Statutory options ("ISOs")

An ISO plan, as a creature of the Internal Revenue Code,

[Section 15:54]

[1]See § 15:53.

[Section 15:55]

[1]For a discussion of stock options, see §§ 38:29 to 38:32.

must meet certain statutory requirements to take advantage of the special tax and accounting benefits afforded such option plans. Specifically, the plan must provide that: (a) all options issued under such plan must be exercised no later than 10 years from the date of grant; (b) options covering no more than $100,000 of the stock of the issuing corporation (measured as of the date of grant) may become first exercisable by any individual employee in any given year; (c) the strike price may not be less than the fair market value of the underlying stock at the date of grant; and (d) the option must be strictly nontransferable. If an ISO is issued to an individual who owns more than 10% of the fully-diluted stock of the issuing corporation, the option must be exercised within five years of the date of grant and the strike price may not be less than 110% of the fair market value of the underlying stock at the date of grant.[1]

If these statutory requirements are met, the executive will not be subject to tax on the receipt of the ISO or upon its exercise. (However, if the executive is subject to the alternative minimum tax, the spread between fair market value of the stock and the strike price will be subject to AMT on exercise.) Rather, the executive will be subject to favorable long-term capital gains treatment on the disposition of the stock if the executive holds the stock for at least two years from the date of the option grant and one year from the exercise date.[2] Of course, if the executive exercises the option due to the sale of the Target, the executive may not have the opportunity to hold the stock for the requisite capital gain holding period, and, therefore, the appreciation in the stock from the date of grant would be taxed at the higher ordinary income tax rates.

If the plan qualifies for favorable tax treatment to executives, there is no income tax deduction available to the Target in connection with maintaining such plan.

Because the option strike price is equal to the fair market value of the underlying equity, the Target will suffer no charge to its earnings for accounting purposes in connection with the maintenance of an ISO plan. This may be important to a VC investor in the Target if its exit strategy features the acquisition of the Target by a public company.

[Section 15:56]

[1]See § 38:32.

[2]See § 38:31.

§ 15:57 Stock options—Non-statutory option plans

As with an ISO plan, a non-statutory option plan provides executives with the right to purchase Target stock at a price and at a time established under the terms of the plan. The major difference is that the non-statutory plan is not subject to the strict statutory limitations and as a result may provide for a strike price that is less than the fair market value of the stock on the date of grant.[1]

While the executive may benefit from receiving a grant of nonqualified stock options with a strike price below fair market value, the actual consequence to the executive, from a federal income tax standpoint, may be less desirable than an ISO. For instance, while the executive will have no income recognition upon the grant of a non-statutory option, he or she will recognize income at ordinary income tax rates and be subject to employment tax withholding requirements on exercise in an amount equal to the spread between the then fair market value of the stock and the strike price. On the flip side, the Target will have a corresponding income tax deduction for the spread.

Where there is an established market for the Target's options, the executive may make an election under I.R.C. § 83(b) to accelerate the recognition of compensation income to the date of grant at a time when the spread between strike price and fair market value of Target stock may be relatively modest. However, generally speaking, no section 83(b) election will be available since it is very unlikely that the Target's options will be marketable, and, as a result, the ordinary income tax element associated with the non-statutory option will stay open until the exercise date.

Because of the compensation element recognized in a non-statutory option plan, the Target will suffer a charge to its earnings from time to time when executives exercise their options, equal to the spread between the option strike price and the stock's fair market value at the date of exercise.

§ 15:58 Interests in entities taxed as partnerships

LLCs taxed as partnerships are at a disadvantage compared to corporations from the standpoint of using equity as

[Section 15:57]

[1]See § 38:30.

compensation for service providers. An interests in profits, and not capital, can ordinarily be issued in exchange for past or future services without causing the recipient to recognize income. But a profits interest does not give the service provider a stake in the appreciation of the LLC, and it requires the service provider to pay tax on a share of the LLC's income. An interest in capital does give the service provider a share of the business's appreciation, but if such an interest is transferred, the service provider has compensation income equal to the value of the interest.[1]

While LLCs can issue options to purchase membership interests that function like nonstatutory stock options, only corporations can issue incentive stock options. The law relating to the taxation of interests in partnership entities that are substantially nonvested and therefore similar to restricted stock is in a state of flux.[2]

§ 15:59 Phantom equity

If the Target wants to avoid giving employees an equity interest, stock appreciation rights and phantom stock plans can be used to provide them with similar incentives. Under these plans, which can be used by both corporations and LLCs taxed as partnerships, employees are rewarded if the value of the Target's value increases.[1] From the employee's standpoint, these plans are less desirable than plans involving actual stock because an I.R.C. § 83(b) election is not available to minimize the tax impact and employees receive taxable compensation income equal to the full benefits paid at the time they are paid.

Another alternative is to establish a deferred compensation plan under which the amount received by the employee depends upon certain business benchmarks. The eventual payout on such a plan treated as compensation income to the employee, but larger payments can be used to soften the impact. The requirements of I.R.C. § 409A must be taken into account to not only ensure that the employee's compen-

[Section 15:58]

[1]See § 8:12.

[2]See § 8:12.

[Section 15:59]

[1]See §§ 38:33 to 38:34.

sation income is deferred but also that the employee is not subject to penalty taxes.[2]

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[2]See §§ 38:14 to 38:17.