VENTURE FINANCING

The absolute number of startup venture financings is greatest at the seed stage. However, most of the total dollar value of venture capital comes from institutional investors in companies that have already raised one or more rounds of seed capital. The institutional investors that serve as sources of capital for startups typically include: venture capital ("VC") funds, in-house VC arms of large corporations, growth-focused private equity funds, large corporations, hedge funds, and mutual funds.

Not all of these investors fund startups at each growth stage. For instance, hedge funds and mutual funds rarely invest in a startup's Series A round but are more likely to invest in later-stage companies that are close to launching an IPO. Similarly, banks who offer venture debt typically only lend to startups that have already received at least one round of institutional VC funding. The instruments that startups use to raise capital from these institutional investors are somewhat more standardized than the instruments issued to investors at the seed stage.

SERIES A FINANCINGS

For startups that have used the seed capital they raised to build a product that allows them to demonstrate that their concept is viable and that an attractive market for the product exists, the next step in their lifecycle usually involves raising a more substantial round of capital from professional institutional investors (typically VC funds). This round of financing most often occurs when companies enter the building phase of growth. It is called the Series A round.

Series A financings typically have the following characteristics:

- Amount raised: Companies usually raise between $3 million and $5 million.
- Investors: Series A investors include venture capital funds focused on investing in early-stage companies and sometimes super-angels.
- Instruments: Investors in VC-led Series A rounds purchase convertible preferred stock almost exclusively.

The terms of a Series A financing and the documents used are largely standardized. There has been a movement among VC firms to embrace standard terms and documents to lower transaction costs for venture financings. The goal is to allow more of the investment proceeds to go toward building the business of the portfolio company instead of immediately leaving the company in the form of lawyers' fees.

SERIES A TERMS

LIQUIDATION PREFERENCE

The terms of Series A Preferred Stock instruments generally provide that, before any proceeds from a sale or liquidation of the company can be distributed to the holders of common stock, the holders of Series A stock (and holders of Series Seed stock, if the company issued preferred stock in its seed round) must first receive a liquidation preference equal to the original purchase price of their preferred shares (known as a 1x liquidation preference). If the proceeds from a liquidation or sale are great enough that the preferred stockholders would receive more than their liquidation preference by converting their preferred shares to common shares, they receive the greater amount. It is uncommon in the current venture finance climate for preferred stock to include a participation (or double-dip) feature. Participating preferred stock provides that the preferred stockholders receive both: the preferred liquidation preference from any sale proceeds and the preferred stockholders' pro rata portion of the remaining proceeds alongside the common stockholders (sometimes up to a certain cap).

DIVIDENDS

Special dividends are a hallmark of preferred stock in most contexts. Yet in Series A financings, many deals simply provide that the common stock cannot be paid a dividend unless the preferred stock receives the same amount on a per share basis. If the parties agree to include a preferred dividend, it is typically not a cumulative dividend and is only paid when and if declared by the board of directors. Since startups are usually losing money, and therefore do not have profits to distribute to shareholders, startups rarely declare dividends in any event.

CONVERSION

Shares of Series A Preferred Stock are convertible into shares of common stock on a 1:1 basis (subject to adjustment in case of certain dilutive events) at the holder's option at any time. In addition, the entire series of preferred stock automatically converts into common stock if: a certain percentage (for example, a majority) of the holders agree to convert their preferred shares; or, the company completes an IPO. Sometimes, for this automatic conversion to apply, the offering must be a Qualified IPO, meaning it meets certain negotiated minimum proceeds or offering price thresholds.

PRICE-BASED ANTI-DILUTION PROTECTION

Most Series A investors negotiate to receive a downward adjustment to the purchase price of their shares if the company later issues common or preferred equity (or other securities convertible into equity) at a price below the Series A price (subject to exceptions for certain types of issuances). If a company does sell stock for less than the Series A price after the Series A round closes (known as a down round), the Series A conversion price adjusts to give the Series A investors more than one common share for each share of Series A preferred stock they hold, if and when the Series A stock converts to common. This is known as a conversion price adjustment, and since the preferred stock of startup companies generally votes on an as-converted to common stock basis, the conversion price adjustment increases the economic value and voting power of the preferred stock.

SERIES A TERMS

PROTECTIVE PROVISIONS

Since Series A investors are almost always minority shareholders who also lack control of the company's board of directors, they usually receive negative control rights over certain actions. These provisions typically require that the delineated actions must receive approval from holders of a majority of the Series A shares before proceeding. These veto rights generally cover critical company actions that impact the economics of the Series A shares, such as: taking actions that adversely affect the rights, preferences, or privileges of the Series A Preferred Stock; amending the company's organizational documents (namely the certificate of incorporation and bylaws); issuing senior or pari passu securities; declaring or paying dividends; redeeming or repurchasing the company's outstanding stock; increasing or decreasing the size of the company's board of directors; and, in some instances, selling the company or all of its assets.

BOARD MATTERS

The lead VC investor in a Series A round is typically entitled to one seat on the company's board of directors (the Series A director). This leaves control of the board to the company's founders but allows the Series A director to be involved in all important decisions. Since the Series A director does not control the board, Series A investors will sometimes require that certain important operational matters be approved by a majority of the board including the Series A director. When the Series A investors do not have a representative on the board, they are usually allowed a non-voting board observer.

REGISTRATION RIGHTS

Series A investors customarily receive demand, piggyback, and shelf registration rights.

FINANCIAL INFORMATION AND INSPECTION RIGHTS

Larger Series A investors are usually contractually entitled to receive certain financial information, including annual, quarterly, and sometimes monthly financial statements, as well as annual operating budgets and financial forecasts. They are also given rights to inspect the company's books and facilities.

RIGHTS OF FIRST OFFER

Larger Series A investors typically receive a right of first offer (also known as a ROFO, preemptive right, or pro rata right) to purchase new securities offered by the company, allowing these investors to maintain their proportional ownership of the company. This right is subject to exceptions for certain issuances (the same types of issuances that are excluded from price-based anti-dilution protection).

RIGHTS OF FIRST REFUSAL

Series A investors generally have the right to purchase the shares of larger common stockholders (such as the founders) when those stockholders seek to sell shares to a third party. The investors' right of first refusal ("ROFR") is secondary to a ROFR over those shares in favor of the company itself.

CO-SALE RIGHTS

If the company and Series A holders do not exercise their rights of first refusal to purchase all of the shares on offer in a proposed transfer, the Series A holders then have the right to sell some of their preferred shares proportionally alongside the selling common stockholder on the same terms the common holder receives (also known as tagging along).

DRAG-ALONG RIGHTS

Series A financing documents often include a drag-along (or bring-along) provision by which smaller stockholders of the company can be compelled to agree to a sale of their shares if the majority of the common stockholders (usually the founders) and a majority-in-interest of the Series A investors are in favor of the sale. This prevents smaller investors from exercising appraisal rights under Delaware law or otherwise preventing or delaying a sale of the company.

MANAGEMENT RIGHTS

Due to certain Department of Labor regulations under the Employee Retirement Income Security Act of 1974 (“ERISA”), most institutional VCs require their portfolio companies to provide a letter granting their funds certain management rights, including the right to consult with the board and management on issues of importance to the company.

The terms of a Series A financing are typically organized into the following five main transaction documents and several additional shorter ancillary documents.

PREFERRED STOCK PURCHASE AGREEMENT

The stock purchase agreement ("SPA") is the document by which the investors agree to pay the purchase price for, and the company agrees to sell, the Series A Preferred Stock. In it, the company makes representations and warranties about its business and the Series A stock. The investors make representations and warranties about their ability to purchase the shares under federal and state securities laws, including a representation that they are accredited investors. The SPA also contains the mechanics of, and conditions to, closing the transaction.

RESTATED CERTIFICATE OF INCORPORATION

Immediately before selling Series A Preferred Stock, a startup amends and restates its certificate of incorporation (also called the charter) to include certain provisions related to the Series A securities, including: the liquidation preference; the preferred dividend, if any; the mechanics of optional and mandatory conversion; structural and price-based anti-dilution provisions; and, voting matters (including providing for a Series A director seat and protective provisions).

INVESTORS' RIGHTS AGREEMENT

The Investors' Rights Agreement ("IRA") is an agreement between the company and the investors that typically governs: registration rights; lock-ups; financial information and inspection rights (which are frequently only given to investors above a certain share threshold, with those investors being designated "Major Investors"); the right of first offer (which is also usually limited to Major Investors); certain obligations of the company surrounding employment matters, including requiring all employees to sign proprietary information and inventions assignments and setting standards for vesting of employee stock options and restricted stock; operational matters requiring the Series A director's approval; insurance matters (such as D&O insurance, or in some limited circumstances, key man insurance as well); Board observers; confidentiality of company information delivered to investors; indemnification of investor designees on the board; and, any other covenants that the investors require from the company as a condition to investing, including any clean-up items that were uncovered in due diligence and that must be remedied post-closing.

RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT

This agreement, sometimes referred to as the ROFR Agreement or the Co-Sale Agreement, contains (as the name implies) the rights of first refusal and co-sale. The agreement is among: the company, who has the primary ROFR; the investors, who have a secondary ROFR and the co-sale rights; and, certain common stockholders of the company (usually the founders, but sometimes any holders of greater than 1% of the company's stock).

SERIES A DOCUMENTS

VOTING AGREEMENT

The Voting Agreement is among the company, all of the investors and, ideally, all of the common stockholders as well. This agreement requires all of the parties to: vote all shares held by those parties in accordance with the Voting Agreement; maintain the size of the board at the number that has been agreed to by the existing stockholders and the Series A investors; vote all shares to elect the lead investor's designee as the Series A director and to elect the designees of the founders or the majority of the common stockholders to the remaining seats; and, agree to the drag-along.

ANCILLARY DOCUMENTS

Several other documents are often needed to close the round, including: board and stockholder consents approving the transaction; various closing certificates; a legal opinion from the company's counsel (if required by the lead investor); management rights letters for investors whose fund agreements require them; indemnification agreements for the directors (including the Series A director); and, stock plan documents (if the company has not yet adopted an equity incentive plan).

Law firms that focus on representing startups and venture capitalists (such as those based in Silicon Valley) each have their own proprietary set of forms for these documents that vary more in style than in substance. The forms used by these firms are largely similar to the model documents that the National Venture Capital Association ("NVCA"), the venture capital industry's trade association, makes available on its website. However, the law firm forms are often somewhat more favorable to the startup and the NVCA forms more favorable to the investors.

SERIES B FINANCINGS AND BEYOND

Startups that have used the funds they raised in their Series A round to build scalable businesses generally continue to raise increasingly large amounts of capital as they focus on pursuing rapid growth. These later rounds of financing, occurring in the scaling phase of the company's lifecycle, are typically named by progressing through the alphabet (Series B, Series C, and so on) for each subsequent round. These financings have the following characteristics:

- Amount raised: The amount raised in these later stages ranges from $5 million to $10 million in a Series B round to upwards of $100 million in a Series E financing. These are rough approximations, as the size of each round varies widely by company, industry, market cycle and circumstance.
- Investors: In Series B and Series C rounds, the investors are predominantly VC funds and sometimes corporate strategic investors. In later-stage financings, VC funds often still participate but are joined by growth private equity funds, and even mutual funds and hedge funds.
- Instruments: Most of these later-stage investors also purchase convertible preferred stock. Once a company has issued Series A convertible preferred stock, it is generally most expedient to continue issuing convertible preferred stock with different terms that are layered on top of the existing Series A documents by amending and restating them.

In post-Series A financings, the negotiation generally focuses on: whose approval is required for the company to take certain actions; who will serve on the board of directors; which actions will require stockholder approval; how much coverage and disclosure the company's representations and warranties should require; and, whether founders and early employees should have an opportunity to sell a portion of their holdings.

VOTING THRESHOLDS

In each subsequent round of financing after the Series A round, a new lead investor typically joins the company's investor base. This results in a multilateral negotiation between the new investor, the company's existing investors, and the company itself regarding whose consent will be required to approve or waive various matters, over which:

- New investors (particularly those that are purchasing enough stock to control an entire series of preferred stock) often want to have series-specific veto rights, mainly over issues where their interests may not be aligned with the earlier investors due to the higher price they are paying for their shares (such as waiving antidilution adjustments).
- Existing investors are reluctant to give new investors veto rights, but if they are willing, they will then likely want similar rights for themselves.
- The company, for its part, would prefer that a majority of its investors rule the day, giving no single investor a veto over any matter.

BOARD COMPOSITION

In conjunction with the negotiation over voting rights, the investors and management typically have to determine an appropriate composition for the board of directors. In a Series B financing round, a typical formulation is to provide that the common stockholders appoint two seats, the investors appoint two seats (one for the Series A and one for the Series B), and those four directors appoint one mutually agreeable independent director. The board size grows in subsequent rounds of financing and there is usually a new negotiation at each stage about who should remain, who should go, and the balance of power (in other words, whether the founders, the investors, or neither group should control the board).

PROTECTIVE PROVISIONS

Later-stage investors (who typically invest at much higher valuations) are generally more focused than early-stage investors on retaining enough control over the timing and nature of an exit event to ensure that they receive a minimum return on their investment. They often seek the ability to block any sale of the company that does not provide them with at least a 2x return on their investment, for instance, even if the rest of the investors (who invested at lower valuations) heavily favor the sale.

REPRESENTATIONS AND WARRANTIES

As startups grow in complexity and scale, and as companies ask their investors to contribute more substantial amounts of capital, the company representations and warranties in the SPA expand in scope with each round (and with each new set of lawyers reviewing the documents on behalf of new lead investors).

FOUNDER AND EARLY EMPLOYEE LIQUIDITY

Founders of startups often have little to no assets outside of their company's stock and do not typically pay themselves anywhere near the salaries that C-suite executives at comparable public companies earn. All of their personal wealth is concentrated in a single risky, illiquid asset. In an effort to diversify, many founders negotiate to include secondary sales of their existing shares as part of the offering to new investors. They sometimes give early employees and angel investors an opportunity to participate in these secondary sales.

As companies are going public much later than was common during the dot-com era, there are often many rounds of private financing and secondary sales of the type described above before a company is ready to undertake an IPO. Indeed, most successful startups are sold before reaching that point.