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Understanding Equity-related Agreements and Considerations

AUTM Webinar

December 13, 2017

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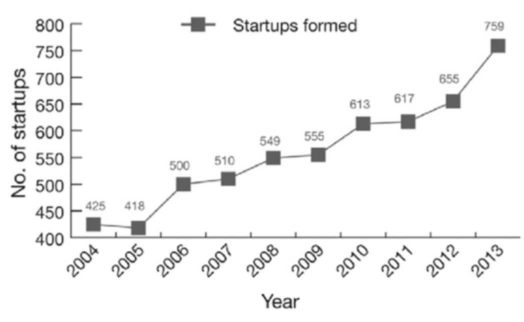
University Start-Ups



VOLUME 32 NUMBER 12 DECEMBER 2014 NATURE BIOTECHNOLOGY

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Equity-related Agreements

- **License agreement: equity-related provisions**
  - Equity class, voting rights, anti-dilution (if any), other rights
- **Entity Organizational Documents**

  Corporation
  - Articles/Certificate of Incorporation – rights and preferences of equity and equity holders
  - Bylaws – Governance/Rules of the Road
  - Stockholders' Agreement – transfer restrictions, voting, covenants (dos and don'ts), drag-along rights, tag-along rights

  Limited Liability Company
  - Operating Agreement: all of the above

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Other typical agreements

- Confidentiality, Inventions, Non-Competition, Non-Solicitation, Non-Interference
- Employment Agreements (sometimes)
- Investor Rights Agreements
- Stock (or Unit) Purchase Agreements
- Term Sheet (non-binding….BUT)
- Stock Options
- Warrants

Choices of Entity

Corporation

vs

Limited Liability Company (LLC)

Corporation

- Treated as a separate "person" and a separate taxpayer
- Liability Shield
- Statutory Legal "defaults"
- "Certainty" with Delaware corporations

LLC

- Separate "person" for liability purposes but "disregarded entity" for tax purposes = tax efficient
- Ultimate flexibility – few defaults; by-product is higher start-up fees
- Less friendly to some investors (LPs of VCs) – some bias for Corporation
- Easy to "convert" from a LLC to a Corporation… but not the inverse

Interests in an Entity

Continuum of

Debt
↓
Equity

- Fundamental Risk-Reward Continuum
- Infinitely Variable Terms
- Legal and Contractual Priority of Payment
- Accounting Considerations

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- Equity generally refers to an ownership interest in a business enterprise. Often used to refer to stock or membership units that represent an ownership interest in a company (i.e., equity security or equity interest)
- In accounting and finance, equity is the difference between the value of the assets and the aggregate amount of the liabilities of something owned. Equity can be negative if liabilities exceed assets
- Equity is illusory unless there is ultimately an exit event or liquidity event, such as a sale of the company, a license of all of its technology if all equity holders sell their interests, or if the equity is freely-tradeable after an IPO

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Fundamental equity attributes:

Economic Attributes

Control Attributes

Not all equity is created equal

- Common stock (voting and non-voting)

- Preferred stock (preferences and attributes)
  – Liquidation/distribution (non-participating and participating)
  – Dividends (cumulative and non-cumulative)
  – Conversion (price and other adjustments; i.e., dilution protection)
  – Redemption
  – Voting

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Common Stock

- Common stock is the simplest form of equity investment. Typically the same security that the founders hold.

- Common stockholders generally have the right to:
- Vote for the company's board of directors and on other stockholder matters
- Receive dividends, if and when declared by the board
- Receive their share of the company's remaining assets if the company is liquidated
- Do not have additional rights, preferences, or privileges of preferred stockholders

Preferred Stock

Preferred stock is more attractive to an investor:

- preferred stock can be issued with a stated dividend rate, which can be cumulative or non-cumulative
- preferred shareholders are paid dividends before common stockholders
- preferred shareholders have superior claim on any remaining assets compared to common shareholders in case of liquidation or sale of assets
- preferred stockholders also do not have voting rights, unless so drafted – venture capital preferred stock almost always includes voting rights

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Four Typical Varieties of Preferred Stock

- **Participating preferred stock** provides its shareholders with the right to be paid a liquidation preference at the preferred level and also participate with the common shareholders on an "as converted basis"

- **Convertible preferred stock** includes a right that allows shareholders to convert their preferred shares into a certain number of common shares based upon a number, price or formula set forth in the articles/certificate

Four Typical of Preferred Stock (cont.)

- **Cumulative preferred stock** requires the company to pay preferred shareholders all accrued dividends, including those that were omitted in the past, before the common shareholders are able to receive their dividend payments. *Important issue upon conversion*
- **Non-cumulative preferred stock** does not pay any omitted or unpaid dividends. If the company chooses not to pay dividends in any given year, the shareholders of the non-cumulative preferred stock have no right or power to claim such forgone dividends at any time in the future. *Important issue upon conversion*

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Redemption Rights for Preferred Stock

- A redemption right is the right of the investors to force a company to repurchase their shares after a specified period of time
- Company rarely has the cash to buy-back the investors' shares and there are significant restrictions under applicable State law regarding redemptions if the company does not have the legally available capital
- Redemption rights sometimes omitted and rarely exercised in a typical venture capital deal, unless and until the Company is at a commercial stage

Alternative Investment Instruments - Convertible Notes

- **A convertible note** is a form of **debt** that converts into equity, typically in conjunction with a future financing round
- The advantage is that it does not force the issuer and investors to determine the value of the company. That valuation is intended to be determined at the next round of financing

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Convertible notes terms:

- **Interest rate:** Accrued interest adds to the principal invested, increasing the number of shares issued upon conversion
- **Discount:** This represents the valuation discount you receive relative to investors in the subsequent financing round, which compensates you for the additional risk you bore by investing earlier (often limited)
- **Valuation Cap:** The valuation cap is an additional reward for bearing risk earlier on. It effectively caps the price at which your notes with will convert into equity (not a common feature)
- **Maturity date:** This denotes the date on which the note is due, at which time the company needs to repay it

Alternative Investment Instruments – Simple Agreement for Future Equity (SAFE)

A SAFE is an early round investment contract (a "security") that grants the investor the right to convert into equity of the company (typically, common stock or common units) on certain triggering events, such as (i) a future equity financing, or (ii) a sale of the company

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Simple Agreement for Future Equity (cont.)

- SAFEs have all of the same conversion features of a convertible note, but lack the debt hallmarks of such notes. A SAFE has (i) no maturity date and (ii) no accruing interest.

- The SAFE is a relatively recent addition to the seed financing toolkit (2013), popularized by the premier startup accelerator, Y Combinator.

Stock Options and Warrants

- **Stock Options**
  Holder has the right, but not the obligation, to buy (exercise) a security at an agreed-upon price (the exercise or strike price) during a certain period of time or on a specific date. Employee/Consultant options usually contain vesting provisions that seek to incent loyalty. Typically, incentive options vest over three to four years and are periodically "refreshed"

- **Warrants**
  Warrants are similar to stock options: right for an investor to purchase a certain number of shares at a predefined price for a certain number of years
  e.g. 10-year warrant for 100,000 shares of Series A stock at $1 per share (regardless of what the stock is worth at time of exercise)

Typically, options are for employee incentives. Warrants are associated with financings and provide investors with a yield-enhancement tool

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Protective terms: Anti-dilution rights

- usually intended to protect against dilution in economic value per share ("price protection"), <u>NOT</u> percentage diminution

- typically implemented by adjustment to the conversion price of preferred stock or convertible debt

- set forth directly in the preferred stock articles

Protective terms: Types of Anti-dilution

- "Full-ratchet" - if shares are issued at a price lower than my price, I get the benefit of the lower price in the conversion formula (i.e., more shares are issued) even if only one share is issued
- "Weighted-Average" – if shares are issued at a lower price, I get a reduction in my conversion price (i.e., more shares are issued) based on the relative amounts of equity issued in the two comparative rounds

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Preemptive Rights

(Investor Rights Agreement)

- Rights granted to purchase additional shares in the company in connection with a subsequent issuance of equity by the Company so that the investor may maintain his/her proportionate interest in the Company after the new financing
- If granted, are usually written into an agreement between the stock purchaser and the company, although a few states grant preemptive rights as a matter of law unless specifically negated in a company's articles of incorporation

Registration Rights
(Investors' Rights Agreement)

- Entitles an investor who purchases stock the ability to require a company to register the shares publicly so that the investor can sell them in the public market
- Two types of rights: demand – requires the company to register and sell for the benefit of the investor; piggyback – requires the company to allow investors to sell along with the company in a public offering
- If exercised, in theory, can force a privately-held company to become a publicly-traded company. Almost never exercised

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Drag-along Rights
(Stockholders' Agreement)

- Drag-along provisions generally require shareholders to agree to sell their equity to a third party if certain investors or a majority of the shareholders want to sell the company or if certain quantitative metrics are met
- A drag-along right is normally triggered in the event of a company merger or acquisition. Buyers are often looking for complete control of a company, and drag-along rights help to eliminate minority owners and sell 100% of a company's securities to a potential buyer

Tag-along Rights
(Stockholders' Agreement)

- Tag-along provisions generally give minority shareholders a right to sell their equity to a third party if the majority shareholders want to sell out
- Tag-along rights used to protect a minority shareholder. If a majority shareholder sells his take, it gives the minority shareholder the right to join the transaction and sell his minority stake in the company, so he/she is not "left behind"

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Voting Rights
(Stockholders' Agreement)

- Contractual provision that commits company stockholders (investors and founders) to achieve certainty about Board structure and representation
- Many "standard" varieties
- Exceedingly important to deal effective with these issues

Employment Terms in CDAs and Agreements

- Usually, at will, but can provide for severance
- Requires all IP to go to the company
- Confidentiality – protects trade secrets
- Non-competition – 1 to 2 years (often tied to severance, but not always)
- Non-solicitation
- Non-interference
- Often, investors require re-restricting founders shares ("reverse vesting")

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Term Sheet

- Should set forth <u>ALL</u> material terms
- Non-binding (<u>BUT</u> significant moral authority and will impair trust if "breached")
- Often contains confidentiality provisions – company info <u>and</u> deal terms
- Often contains a market stand-off provision (30-90 days), usually not paid for
- Often, investor fees are paid by the company . Usually subject to a cap

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Purchase Agreement

- Binding contract
- Purchase terms
- Representations and Warranties and Indemnification
- <u>Even if it seems duplicative of due diligence – this is where it counts!</u>

- Investor fees paid by company; often capped

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Questions???

Last slide

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Marc Singer
Osage University Partners
msinger@osagepartners.com

Michael D. Poisel
PCI Ventures
University of Pennsylvania
mpoisel@upenn.edu