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<ul style="list-style-type: none"><li>▶ Background on Pre-Emptive Rights of First Offer<ul style="list-style-type: none"><li>▶ Pre-emptive rights are the rights of stockholders to purchase their <i>pro rata</i> portion of securities offered by the corporation.</li><li>▶ Calculation of <i>pro rata</i> often subject to negotiation.</li><li>▶ Commonly calculated in one of the following ways:<ul style="list-style-type: none"><li>▶ <i>pro rata</i> based on the total amount of securities held by the stockholders who have pre-emptive rights; or</li><li>▶ <i>pro rata</i> based on the total amount of securities held by all stockholders.</li></ul></li></ul></li></ul>	

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<ul style="list-style-type: none"><li>▶ <b><u>Super Preemptive Rights.</u></b><ul style="list-style-type: none"><li>▶ Early investors may seek for "super" pre-emptive rights that enable them to purchase securities in excess of the <i>pro rata</i> portion (e.g., fixed dollar amount, 50% of next round).</li><li>▶ Like many of the issues in follow-on financings, whether or not this type of existing provision should be waived in connection with a follow-on financing will depend upon the negotiations between the corporation, the new investors and the existing investors. This three-party interplay is a critical element of executing a successful follow-on financing.</li></ul></li><li>▶ <b><u>Over-allotment.</u></b> Investors who elect to purchase their <i>pro rata</i> portion of securities in the offering typically also have the right to "oversubscribe" and purchase their <i>pro rata</i> portion of any securities which were not subscribed for by other investors who had pre-emptive rights.</li></ul>	

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<ul style="list-style-type: none"> <li>▶ Drafting point – If investors ask for a “super” pre-emptive right make sure it has a sunset provision so that it terminates at a specified point in the future (e.g., after the next equity financing).</li> <li>▶ Pre-emptive rights are typically created by contract (e.g., in an investor rights agreement).</li> <li>▶ Certain types of issuances are commonly excluded from pre-emptive rights such as the issuances of equity compensation to a corporation’s employees.</li> <li>▶ Waivers will be required to allow for an allocation of the new securities in a manner different than is specified in the existing agreements (very common). This type of allocation sometimes occurs when a new investor requires ownership of a portion of the new securities that prevents the existing investors from purchasing their previously negotiated <i>pro rata</i> portion.</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ In certain instances a corporation may want to offer pre-emptive rights to stockholders other than those that possess contractual pre-emptive rights. Commonly referred to as a “Rights Offering.”</li> <li>▶ Rights Offerings are common in down-round financings because a corporation wants to mitigate risk by allowing all stockholders to participate.</li> <li>▶ Important to ensure that the rights offering complies with securities laws -- may be necessary to limit the rights offering to accredited investors.</li> <li>▶ Rights offerings are often accompanied by an “information statement” or similar disclosure. Careful consideration should be given to contents. There is risk to being overly positive, and also risk to being overly negative in the disclosure.</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Pay-to-play provisions are sometimes linked to contractual pre-emptive rights to provide “teeth” to the pre-emptive rights. Pay-to-play provisions impose penalties on investors that do not purchase their <i>pro rata</i> share of new securities in a financing.</li> <li>▶ Penalties imposed by pay-to-play provisions can include the following:             <ul style="list-style-type: none"> <li>▶ conversion of preferred stock into common stock;</li> <li>▶ loss of contractual rights (e.g., board seat or future preemptive rights);</li> <li>▶ conversion into a junior preferred stock which is lower down in the liquidation waterfall or loses other rights (e.g., anti-dilution, voting rights, etc.); and</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Penalties can be “all or nothing” where the conversion or loss of rights occurs if the existing investor does not purchase his, her or its full <i>pro rata</i> portion or the penalties can be “prorated” where only a portion of the investor’s preferred stock is converted or loses rights based on the amount of securities purchased compared the full <i>pro rata</i> portion.</li> <li>▶ Pay-to-play provisions sometimes apply to all follow-on financings or just to <u>certain</u> follow-on financings based on factors such as whether the round is an up-round or a down-round or based upon the size of the round.</li> <li>▶ The Delaware Chancery Court has upheld the validity of pay-to-play provisions where all preferred stockholders have an equal opportunity to participate in the financing that triggers the pay-to-play provisions (see <i>WatchMark Corp. v. AGRO Global Capital, LLC, et. al.</i>).</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <b>Statutory Approvals</b></li> <li>▶ The approval of a majority of (i) the board of directors and (ii) the stockholders is typically required for the issuance of new securities and is required for the amendment of the certificate of incorporation to create the new securities.</li> <li>▶ Some states have statutory provisions that govern the approval requirements for interested party transactions. For example, the Delaware General Corporation Law (the “DGCL”) Section 144 states that, “No contract or transaction between a corporation...and any other...partnership...in which 1 or more of its directors...have a financial interest, shall be void or voidable solely for this reason...if:</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ The material facts as to the director’s...interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum (DGCL 144(a)(1)); or</li> <li>▶ The material facts as to the director’s or officer’s relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders (DGCL 144(a)(2)); <u>or</u></li> <li>▶ The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders (DGCL 144(a)(3)).</li> </ul>	

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	<p>► For protection of DGCL 144(a)(3) to apply, directors bear burden of proving "entire fairness", which requires proof of both:</p> <ul style="list-style-type: none"> <li>► Fair dealing (that is, that the transaction process was fair); and</li> <li>► Fair price (that the financial terms of the transaction were fair).</li> </ul>	

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	<p>► <i>In re Trados, Inc. Stockholders Litigation</i> – important new case:</p> <p>Where the interests of the common and preferred stockholders diverge, the board of directors could breach its fiduciary duties by improperly favoring the interests of the preferred stockholders over those of the common stockholders.</p> <p>► Hot area in Delaware? March 8, 2010 QuadraMed decision.</p>	

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	<ul style="list-style-type: none"> <li>► DGCL 242(b)(2) is an important provision in the DGCL.</li> <li>► Unless otherwise provided in the certificate of incorporation, this section affords holders of common stock a separate class vote for any increase in authorized common stock.</li> <li>► In order to avoid the application of this provision, a certificate of incorporation must expressly provide that preferred stock and common stock vote together as a single class.</li> <li>► This section also provides that if an amendment adversely alters the rights, preferences and powers of one series of preferred stock, then that series has a separate series vote.</li> <li>► This separate series vote is <u>not</u> triggered by creation of new series of senior preferred stock.</li> <li>► Always check the charter!</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Contractual Approvals or Protective Provisions             <ul style="list-style-type: none"> <li>▶ Require a separate series or class vote of preferred stock to undertake certain corporate actions (e.g., sale of the corporation, creation of new series or class of stock, etc.).</li> <li>▶ Provisions should be triggered if proposed action is to be taken directly or indirectly "by amendment, merger, consolidation or otherwise" (critical language after the <i>Benchmark Capital Partners IV, L.P. v. Vague</i> case in the Delaware Chancery Court)</li> <li>▶ Understand the voting thresholds and the blocking rights which are established.</li> <li>▶ Especially sensitive in later rounds or if financing round includes multiple investors with possible differing interests (e.g., a single round that includes existing investors and new investors.)</li> <li>▶ Be careful of "preferred director approvals" in lieu of obtaining stockholder approval and related fiduciary duty concerns.</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Be careful when asked to give veto or blocking rights to new investors on the issuance of new securities or consummation of a merger because the economic interests may not be aligned with existing investors and management. Consider providing these veto or blocking rights only in certain issuances or only where the merger does not provide a return above a certain threshold (e.g., 3X the liquidation preference).</li> <li>▶ Drafting point – When drafting protective provisions in connection with follow-on financings, attempt to create single class votes whenever possible so that no single series (or investor) controls or has a block on the protective provisions. Keep protective provisions streamlined and simple.</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Issue: raising money at valuation that is lower than last round</li> <li>▶ Typically triggers anti-dilution protection (unless waived)</li> <li>▶ If led by insiders, implicates fiduciary concerns -- who sets valuation?</li> <li>▶ Pejorative term (to be avoided) -- "cram down" or "wash out" financing</li>   <li>▶ <i>In re Trados, Inc. Stockholders Litigation</i> – important recent case: Where the interests of the common and preferred stockholders diverge, the board of directors may breach its fiduciary duties by improperly favoring the interests of the preferred stockholders over those of the common stockholders.</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <i>Alantec</i> case <ul style="list-style-type: none"> <li>▶ Oppression of minority interest claim</li> </ul> </li> <li>▶ Breach of Duty of Care <ul style="list-style-type: none"> <li>▶ Board did not instruct management to seek alternative financing</li> <li>▶ Sale of ABC, Inc. (and not financing) was in best interests of common stock holders</li> <li>▶ Investors used position of power to self-deal</li> </ul> </li> <li>▶ Breach of Duty of Loyalty <ul style="list-style-type: none"> <li>▶ Investor-director received benefit of discounted stock</li> <li>▶ Investor-director benefited due to anti-dilution rights (especially with full ratchet)</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Lack of reported case law <ul style="list-style-type: none"> <li>▶ Founders lack resources or concerned about reputation</li> <li>▶ VCs do not want reputation of suing portfolio companies</li> </ul> </li> <li>▶ Case law factors not clear <ul style="list-style-type: none"> <li>▶ Motives of investor-directors heavy factor in leading case that ultimately settled (<i>Alantec</i>)</li> <li>▶ Permitting all stockholders to participate strong defense but not dispositive</li> <li>▶ Timing of need for funds major factor (i.e., emergency financing to meet payroll)</li> <li>▶ Exhaustive attempt to explore other financing or strategic options prior to down round financing?</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Approval of disinterested directors <ul style="list-style-type: none"> <li>▶ Interested director should make full disclosure to board</li> <li>▶ Disinterested director should approve transaction at meeting without participation of interested directors</li> <li>▶ Such approval does not fully insulate claim as stockholders could still claim breach of duty of care</li> </ul> </li> <li>▶ Approval of Stockholders <ul style="list-style-type: none"> <li>▶ Disclose details of transaction to stockholders</li> <li>▶ Seek unanimous (or close to unanimous) approval of stockholders</li> <li>▶ Get waivers from non-participating stockholders</li> <li>▶ If transaction fully disclosed and 100% approval obtained, should protect directors</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Obtain third-party appraisal             <ul style="list-style-type: none"> <li>▶ Create some record (see below)</li> <li>▶ May have limited value as company usually has some influence over appraisal</li> </ul> </li> <li>▶ Often impractical             <ul style="list-style-type: none"> <li>▶ Time Consuming</li> <li>▶ Expensive</li> </ul> </li> <li>▶ Seek new lead investor to set price             <ul style="list-style-type: none"> <li>▶ Shows market factors at play</li> <li>▶ Reduces amount of self-interest of current investor</li> <li>▶ Attempts to find lead investor create paper trail to defend valuation (see below)</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Offer investment to all stockholders             <ul style="list-style-type: none"> <li>▶ Preemptive rights could be offered even if not required by law or contract</li> <li>▶ Case law precedent sets some defense</li> <li>▶ May not "level playing field" because existing common stockholders can argue that they do not have capital</li> </ul> </li> <li>▶ Build a record of motives             <ul style="list-style-type: none"> <li>▶ Keep record of business exigency</li> <li>▶ Add detail of board discussions to minutes</li> <li>▶ Keep records of other attempts to raise money</li> <li>▶ Disclose to all stockholders</li> <li>▶ Don't make statements like "the founders already have too much stock"</li> <li>▶ Create record of offering different incentives and rights to compensate founders</li> <li>▶ Allow common stock holders to participate in financing</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ Purpose of Interim Financings</li> <li>▶ Is it a bridge? Or a pier?</li> <li>▶ Key Issues:             <ul style="list-style-type: none"> <li>▶ appetite of existing investors/cohesiveness of investor syndicate</li> <li>▶ insider / fiduciary considerations</li> <li>▶ pay-to-play? rights offering?</li> <li>▶ short term versus permanent: prospect of a near-term, new financing</li> <li>▶ debt versus equity</li> <li>▶ administrative burden and costs (consents/approvals, documentation, legal fees, delay)</li> <li>▶ subordination to existing lenders</li> <li>▶ consider what happens on maturity of bridge notes -- default conversion into equity?</li> <li>▶ consider what happens if Company sold prior to maturity of bridge notes</li> </ul> </li> </ul>	

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<p>► Summary: a simple, straight bridge note financing in which the notes convert into the next financing round at no discount or a modest discount (say 10%-15%)</p> <p>► Pros:</p> <ul style="list-style-type: none"> <li>► quick; limited documentation</li> <li>► minimal cost to the Company (also limited management and legal cost)</li> <li>► less extensive consents and waivers (need stockholder/board consents, but no charter amendment)</li> <li>► if the Company ultimately fails, the noteholders are first in line after secured creditors (but in bankruptcy...)</li> <li>► most importantly, no need to settle on valuation or investment terms</li> </ul>	

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<p>► Cons:</p> <ul style="list-style-type: none"> <li>► debt not equity on the Company's books</li> <li>► divergent interests can arise at a later date as the maturity date approaches</li> <li>► following maturity, noteholders can take legal action to enforce the note and ultimately may succeed in encumbering or seizing assets (concern is heightened with strategic investors)</li> <li>► in current market, bridge investors sometimes require a multiple return (e.g., 3X) on repayment if the Company is sold prior to maturity</li> </ul>	

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<p>► Variations/ Considerations:</p> <ul style="list-style-type: none"> <li>► interest rate: typically 8-10%</li> <li>► maturity / term: typically 3-12 months</li> <li>► usually only existing investors will take this approach</li> <li>► secured versus unsecured</li> <li>► subordination with other lenders</li> <li>► Doctrine of Equitable Subordination</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <b>Summary:</b> same as above, but with either warrant coverage (10%-25% of loan amount) or a conversion discount that is significantly greater (15% +)</li> <li>▶ <b>Pros:</b> same as above plus: <ul style="list-style-type: none"> <li>▶ may require additional consents depending on warrant issuance</li> </ul> </li> <li>▶ <b>Cons:</b> same as above plus: <ul style="list-style-type: none"> <li>▶ when pitching to new venture investors, onerous bridge terms send signals of desperation</li> <li>▶ conversion discounts above 20% often scare off prospective investors</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <b>Variations / Consideration:</b> same as above plus: <ul style="list-style-type: none"> <li>▶ note sometimes starts with a lower-range discount, which increases over time (e.g., 0% discount if you close round within 30 days, 15% discount if closed within 60 days, 25% discount if closed within 90 days, etc.)</li> <li>▶ optics of this approach are somewhat better than an immediate discount in the 10-25% range</li> <li>▶ remember to check for carveout from preemptive rights and anti-dilution protection for warrant issuance</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <b>Summary:</b> Re-open the last round, amend the Company's charter to increase the number of authorized shares of Preferred Stock and sell additional shares at the same price to willing participants</li> <li>▶ <b>Pros:</b> <ul style="list-style-type: none"> <li>▶ fairly easy to paper</li> <li>▶ avoids debate over valuation and terms by sticking with what's already in place</li> </ul> </li> <li>▶ <b>Cons:</b> <ul style="list-style-type: none"> <li>▶ a recent flat round like this may make a step in valuation difficult with new investors</li> <li>▶ requires a charter amendment and amendments to existing investment documents and therefore more extensive stockholder consents and waivers necessary</li> </ul> </li> </ul>	

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<ul style="list-style-type: none"> <li>▶ takes more time on the part of management and counsel and therefore is more costly</li> <li>▶ <b>Variations / Considerations:</b></li> <li>▶ usually only works with existing investors (so inside round issues apply)</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <b>Summary:</b> Amend the Company's charter to create a new derivative security (i.e., "Series C-1") and sell to willing participants (derivative security terms, other than price, are usually identical to the last round)</li> <li>▶ <b>Pros:</b></li> <li>▶ limits negotiations by using existing investment documents and terms as baseline</li> <li>▶ allows "surgical" changes to existing investment documents (i.e., price per share)</li> <li>▶ relatively easy to paper</li> <li>▶ equity rather than debt and thus stronger balance sheet</li> </ul>	

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<ul style="list-style-type: none"> <li>▶ <b>Cons:</b></li> <li>▶ more complicated than other interim financing alternatives</li> <li>▶ existing investors may be opposed; this is a fairly novel approach requiring more negotiation</li> <li>▶ requires a charter amendment and amendments to existing investment documents and therefore stockholder consents and waivers necessary</li> <li>▶ takes more time on the part of management and counsel and therefore is more costly</li> <li>▶ <b>Variations / Considerations:</b></li> <li>▶ used with both down rounds and up rounds</li> <li>▶ sometimes includes a "pay to play" feature</li> <li>▶ consider anti-dilution adjustments that may be triggered</li> </ul>	

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