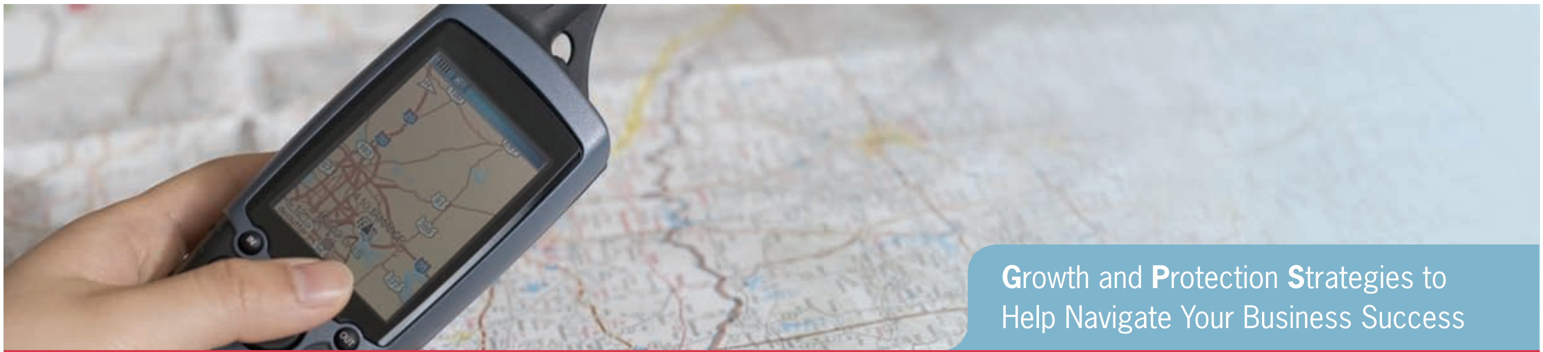

Legal:GPS

Doing the Deal — Reading and Understanding the Fine Print

By: Lauren Flanagan, Phenomenelle Angels Fund 1, LP and
Anne E. Ross, Foley & Lardner LLP

"Doing the Deal — Reading and Understanding the Fine Print" was the topic for the March 12, 2008 installment of the Legal:GPS Web conference series, presented by Foley & Lardner LLP and Springboard Enterprises. Springboard alumna Lauren Flanagan, Managing Director and co-founder of the Phenomenelle Angels Fund 1, LP, an early-stage private equity fund, and Anne E. Ross, Partner and member of Foley's Private Equity & Venture Capital Practice, discussed strategies and insights for understanding and negotiating term sheets and due diligence documents.

Preparing a Company for Financing

Many start-up companies seeking investment do not realize there are many steps that need to be completed before beginning any discussions with investors. Entrepreneurs and start-ups must be prepared adequately both internally and structurally. Preparation includes organizing the company as the proper legal entity, establishing the needed intellectual property protections, having accurate and updated financial records, electing at least one independent board member, and securing employment agreements. These and other key details form the basis of a "due diligence" binder, which contains all of the due diligence information that investors will want to see when evaluating investment decisions. At this early stage, it also is important to consider having knowledgeable legal and financial advisors.

Choosing the Right Investors

Once the company is in order internally, entrepreneurs should exercise the same scrutiny on potential investors as investors will on them. Entrepreneurs are advised to review carefully a select group of venture capital firms that have synergies with their portfolio companies, fund companies in similar industries or markets, and have the capacity to meet the investment size and structure sought. Legal counsel and financial advisors often work with investors and can help arrange personal introductions, which can be essential since many venture capital firms receive hundreds of inquiries a week. Since the investment represents much more than a financial relationship, it is critical that companies and investors have similar communication styles and most importantly, trust each other, in what will be a long-term relationship.

Legal Representation and Negotiations

After finding the right investors, the real work of the deal begins. Experienced legal counsel can help in preparing for the negotiations by defining the term sheet's negotiable points. A particular topic of interest to the investors will be the founder's role and compensation, as investors often want a strong say in the leadership of the company after they have invested in it. Throughout the discussions, disclose everything to prevent problems from arising later and to build trust between the parties. As the negotiations progress, focus on the areas of agreement before addressing any disagreements to keep the deal moving forward. The presenters noted that the most common point of disagreement is valuation of the company, even though it is much more important to build a strong, lasting relationship with investors than to focus on a dollar value of the company at an early stage. Investors understand the need to value a company with enough room to allow for future rounds of investments and greater valuations in later stages of maturity.

> *"The tendency is to really get fixated on getting a certain price, and my counsel is for you to get fixated on finding the right investors who are going to be with you through as much time as you need and as many rounds the funding as you need."*
>
> Anne E. Ross, Foley

The Due Diligence Process

In the due diligence process, everything is open to the investor's scrutiny. Companies can prepare for this lengthy process by understanding what investors typically seek during the due diligence

FOLEY
FOLEY & LARDNER LLP

Springboard ENTERPRISES

review and by preparing a due diligence binder or a special secure Web site with the information investors will want to know about the company. Entrepreneurs also should be prepared to make changes to their companies during the due diligence process, which often will uncover issues that the investors want resolved as a condition of investment. If a company has many of the due diligence items prepared and possible change requests anticipated, investors will be impressed by the company's management, which can help speed the otherwise complicated due diligence process.

> *"Guy Kawasaki likes to say due diligence is what venture investors do to convince themselves their gut decision's right."*
>
> Lauren Flanagan, Phenomenelle Angels Fund 1, LP

The Term Sheet

Using a Series A round venture capital investment as an example, a typical term sheet is divided into two parts: the non-binding provisions and the deal terms. Legal and financial advisors who know the industry understand what can be negotiated and what are industry standard terms. Given the close nature of the venture capital community it is important to not make the mistake of negotiating on points that are industry standards, which can damage reputations for future deals. Entrepreneurs also are advised to remember the fiduciary responsibilities of investors, especially those who represent large institutional investors, which may limit the investor's flexibility in negotiations.

The non-binding provisions describe the often standard terms by which the transaction will close, subject to due diligence and the negotiation of definitive agreements. Often a standard, bulleted list of common aspects of the deal, the term sheet lists many areas, including the total amount to be invested in the round, the type and class of securities, preferential dividend, liquidation preference, anti-dilution protection, and other common deal terms. One of the terms, board representation and observer rights to allow the investor to sit on the company's board, often is a negotiation point. The panelists explained that entrepreneurs should not fear this particular term item but instead, should see it as a great benefit to the company. A good venture capitalist can provide a start-up company with a wide range of business advice, find key employees, and help identify and form strategic partnerships. Another important non-binding provision is super majority voting rights, which give the investors as a group the ability to veto certain key transactions or changes to the company. For the entrepreneur, it is important to structure the deal in a way that prevents small investors from having individual veto rights. Instead, one or two investors should control the investor group voting.

Binding Provisions and Definitive Documents

The key binding provisions include the areas of confidentiality, "no shop" agreements, expenses, and the expiration date of the term sheet. Of these items, the "no shop" agreement is particularly important, as it prevents the entrepreneur from seeking competitive deals with other investors during the due diligence and term sheet negotiation process. These agreements typically were once found in mergers, but are more common in early stage venture capital rounds today.

Once the term sheet negotiations conclude, the terms of the deal are agreed to formally in the definitive documents. The investor's counsel will prepare several contract drafts, which should be reviewed carefully by both sides and their legal counsel to make sure the definitive documents accurately describe what was agreed to in the term sheet negotiations.

> *"As they say, the devil's in the details. You want to be well represented during this stage of the deal."*
>
> Anne E. Ross, Foley

A Signed Deal Is Not a Done Deal

After the deal is signed and the investment is made, the real work begins. Entrepreneurs must now partner with the investors who own a portion of the company to grow the start-up, meet the milestones set forth by the investors, pursue additional rounds of financing as needed, and move toward the exit strategy: a public offering or merger.

> *"You now begin the new life of your company, which first of all, is no longer your company, it's now owned by investors.*
>
> Lauren Flanagan, Phenomenelle Angels Fund 1, LP

Conclusion

Raising capital is one of the many challenges entrepreneurs and start-up companies face. By understanding the investment process, how to prepare the information investors will seek, what to look for in an investor, and the lengthy and thorough process of closing the deal, entrepreneurs can improve their chances of securing the capital they need to move their business forward.