

Morgan Lewis

**BUSINESS ANGELS, INVESTORS
AND ENTREPRENEURS
IN EMERGING COMPANIES**



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Partner

More than 15 years of experience in venture capital in France

- 1994: IPO of Business Objects
- 1995: First trip to Silicon Valley
- 1997: Creation of CroissancePlus and contribution to the creation of the French SOP (BSPCE)
- 2004: Reform of the securities and creation of the restricted stock (AGA)
- 2006-2010: Best French Law Firm in Venture Capital (PE Magazine / Décideurs Juridiques & Financiers / Chambers)

Emerging companies go through different stages

- Creation
- Funding: Seed & VC Capital
- Expansion: local et international
- Mergers & Acquisitions
- IPO
- Secondary
- Growth

Organize yourself: delegation

- Organization and delegation
 - It is a must: you cannot do everything*
- Keep what you are good at:
 - *This is what you do best*
 - *Delegate the rest*
- Nothing is eternal
 - *Life is change*
 - *Challenge your strategy periodically*

Organize yourself: counsels

- Whatever your option, you will need outside counsels:
 - *Auditors, head hunters, bankers, lawyers, analysts etc...*
- To each stage its counsel
- None of them is universal:
 - *Commercial banks v. investment banks, etc...*
- What do you need them for?
 - *Save time*
 - *Stay away from trouble*
 - *Concentrate on your core activity*

Organize yourself: counsels

- **How to choose your counsels:**
 - *Use your network, not the yellow pages*
 - *Privilege experience & knowledge over enthusiasm*
 - *Look for the fit*

Organize yourself: **counsels**

- **Be friendly but firm**

- *Most consultants are with you for the short term*
- *And you will spend lots of time with them*
- *Be nice but ask for results*
- *You will stay for a long time with your auditors*
- *You should stay forever with your lawyer...*

Organize yourself: counsels

- **It won't be a bed of roses:**
 - *There will be crisis and conflicts*
 - *You need to be able to trust your counsels*
 - *You will have to rely on them in difficult times*

Organize yourself: Funding

- **Choice of VC(s):**
 - *Apply the same rules as for your counsels*
 - *The highest valuation is not the right criteria*
 - *The less VC(s), the better*
- **Anticipate & get ready:**
 - *It always take more time than you expect*
 - *The company will no longer be yours: dilution & obligations*
 - *You may not be the man of the situation for ever*
 - *What do you want to get out of your VC(s) ?*

Funding

- **The present:**
 - Term sheet
 - Investment agreement
- **The future:**
 - Shareholders Agreement
 - Founders / management team
- **The tools:**
 - Preferred shares & ratchet
 - Shareholders Agreement & liquid pref
 - ESOP

Term sheet

- **Key element, all is in the term sheet**
 - *Do not negotiate alone*
 - *Do not wait until the last minute to pick up your counsel(s)*
- **What is all?**
 - *Valuation*
 - *Investment terms: split / syndication / milestones etc...*
 - *Instruments*
 - *Reps & warranties*
 - *Investors' rights*
 - *Management terms & conditions*

Where will “all” be implemented ?

- Valuation: investment agreement
- Investment terms: investment agreement
- Instruments: investment & shareholders agreement
- Reps & warranties: investment agreement
- Investors' rights: instrument & shareholders agreement
- Management terms: term sheet, shareholders agreement & resolutions

Investment agreement

- **Valuation & investment terms**

- *Need & choice of a fund raiser*
- *Quantity v. quality*

- **Instruments: trust your lawyer**

The « instruments » that will be used by the investor to take a stake in the company are mainly shares (common or preferred) or bonds (convertible or redeemable in shares)

Investment agreement

▪ Reps & warranties

- *Goal: establish investors' confidence on the substance of the company*
- *Reps & warranties should be prepared carefully:*
 - *Beware, it is a time consuming, ungratifying job that entrepreneurs usually postpone until the last minute*
 - *It is a mistake*
 - *The sooner you work on it, the better it will be*
- *Principle:*
 - *Anything you declare (provided it is correct of course) will exempt you from liability*
 - *Be specific. Investors will not accept general or vague descriptions*
- *Consequences:*
 - *In case of any error, inaccuracy or omission, a compensation (cash and/or shares) will be allowed to investors pursuant to the agreement*

Investor's rights

- **What are they ?**
 - *Political*
 - *Economic*
- **Where are they ?**
 - *Political: shareholders' agreement & preferred shares*
 - *Economical: preferred shares & shareholders' agreement*

Investors' economical rights

Shareholders' agreement

- ↗ Liquidation preference
- ↗ Liquidity clause

Preferred shares

- ↗ Liquidation preference
- ↗ Anti-dilution

Investors' economical rights: Anti-dilution

- **Distinction to be drawn:**
 - *The French meaning: pre-emption right*
 - *The American meaning: the ratchet mechanism*

- **Grounds of the ratchet mechanism:**
 - *Payment of a premium when investing*
 - *For a given share of the assets*
 - *Based on a given valuation*

Investors' economical rights: Anti-dilution

- **The method**

- the ratchet*

- **The tool box:**

- the warrants
- the convertible bonds
- the preferred shares

Investors' economical rights: Anti-dilution

▪ The tools

- the « *full ratchet* »*
- the « *weighted average* »*
- the « *pay to play* »*

- the lowest of all
- the average
- complexity

Anti-dilution: Implementation in France

Prior to 1995

↗ a mix of shares &
obligations

1995

↗ creation of shares with
equity warrants attached
(ABSAs)

Anti-dilution: Implementation in France

2004

- Creation of the preferred shares

Post-2004

- preferred shares
- persistence of bonds
- persistence of ABSAs

Investors' economical rights: liquidity & preference

- **Liquidity: sale or IPO**

- Term: 3 to 5 years
- The grounds

- **Implementation**

- From the « *Mexican shout out* » to the investment bank
- From the « *tag along* » to the « *drag along* »
- The management's leverage

Investors' economical rights: liquidation preference

- **The grounds:**
 - *Management should not collect before the investors do*
- **The American way:**
 - *The « preferred shares »*
 - ↳ *A comprehensive instrument with all rights included*
 - ↳ *In France, we have to split the rights*

Investors' economical rights: liquidation preference

THE DIFFERENCE:

- ↗ The French liquidation:
 - *Dissolution*
 - *Voluntary or judicial liquidation*
 - *Bankruptcy*

- ↗ The anglo-saxon liquidation:
 - *Sale (company or assets)*
 - *Merger*

THE TOOLS:

- ↗ The preferred shares:
 - *Protection of existing securities*
 - *Special audit procedure*

- ↗ The shareholders agreement

The shareholders' agreement

- Is a partnership agreement
- Not a Sale & Purchase Agreement
- Its structure will reflect it
- **Main features**
 - Restrictions on stock transfers
 - Management of the company
 - Key managers

The shareholders' agreement

Restrictions on stock transfers

Right of first refusal

Shares of the company may not be sold without being first offered to the other shareholders of the company:

- At the same price and conditions
- With or without a preference for members of the same category of shareholders

The shareholders' agreement

Restrictions on stock transfers

Tag along (full)

Any shareholder – acting alone or in concert - will be prohibited from transferring shares

- If it would result that the buyer would take control of the company
- Except if the buyer has to buy all the remaining shares to the existing shareholders at the same price and conditions

The shareholders' agreement

Restrictions on stock transfers

Tag along (proportional)

- If the founder intends to sell a part of its stake in the company to a third party (non-affiliate company)
- Investors are authorized to sell their stake on a proportional basis on the same terms and conditions

The shareholders' agreement

Restrictions on stock transfers & Liquidity

Drag along

- If a party offers to take over the company at price and conditions accepted by shareholders or preferred shareholders holding a given percentage of the share capital of the company, the remaining shareholders are committed to sell their shares at the same price and conditions

The shareholders' agreement

Liquidity

IPO

Rule of thumb: Parties agree that the shares of the company have to be listed within 3 to 5 years at predefined conditions:

- Listing of X % of the share capital
- Minimum valuation equal to X times the initial valuation
- Underwriting commitment
- No secondary offering during a period of Y months following the IPO
- Usual registration rights (for US markets)

The shareholders' agreement

Liquidity

Sale of the company

If, after a given period of time (3 to 5 years), no IPO or other liquidity opportunity has taken place, the investors may force the sale of the company:

- Either by direct sale, a merchant bank being appointed, or
- By implementing a buy back type of clause

The shareholders' agreement

Management of the company

Parties agree on:

- The type of company and governance : Limited liability company (*société anonyme*) with a board of directors (*conseil d'administration*) or management board (*directoire*) / supervisory board (*conseil de surveillance*) – Simplified joint stock company (*société par actions simplifiée*)
- The maximum number of board members
- The participation of the investors to the board

The shareholders' agreement Management of the company

Decisions requiring the prior agreement of the investors

- Through unanimous vote or vote of a qualified majority at the board level, or
- Prior authorization of preferred shareholders (single class or several)

Content of such decisions to vary from one deal to another according to the development stage of the company

The shareholders' agreement Information rights

- Investors or Board members or both as the case may be, shall be provided with specific information
- The content of such information is very standardized

The shareholders' agreement

Key men

- **Lock-up**

- Rule of thumb:

- Each team member identified as “key” may not sell his shares before the investor can actually realize its financial gain

- Implementation

- Duration
 - Tag along (proportional)
 - Claw back (good leaver / bad leaver)*
 - Exceptions : tag along, drag along & respiration

The shareholders' agreement

Key men

- **Non-compete**

Each key man will agree that for the duration of his employment and for a given period of time thereafter he will not compete with the company or hold any ownership interest in any competitor of the company

The shareholders' agreement

Key men

Insurance

The company will enter into an insurance policy to cover:

- The invalidity and death risk for every key man
- The unemployment risk of the General Manager
- The directors and officers liability

The shareholders' agreement

Key men

Intellectual property

The company shall see that intellectual property ownership is duly transferred to itself by its employees and employees of its subsidiaries

Glossary

The « Mexican shout-out »

clause:

Investors who wish to sell their stake after a predefined period (usually 3 to 5 years) must proceed to a valuation of the company and ask the founders if they agree to sell their stake at that price. If the price proposed does not satisfy the founders or if they simply refuse to sell, the founders can instead buy their shares at the above said price.

Claw back:

The key principle is that the investor does not only invest in a project. It is both a project AND a team. Neither should a member of the team resign before the project is on track, nor should a team member act or commit a fault that could lead the company to fire them or to discharge them (« bad leaver »). Therefore, should that case occur, the investor can buy the founders' shares at a punitive price. The resulting price will therefore be very low.

Ratchet:

The ratchet is a formula that enables to lower the price per share paid by the investor. It protects the investor from a possible decrease of the value of the company. The « **full ratchet** » brings the share price down to the lowest of all prices of any capital increases completed at the date the ratchet is exercised. The « **weighted average** » brings the share price down to the weighted average price of all capital increases completed at the date the ratchet is exercised. The « **pay to play** » limits the investor protection. Its protection shall vary according to its participation to further capital increases.