Strategic Planning for the Closely Held Business -- Where to Go Beyond Bank Debt and Internal Growth

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Strategic Issues for Business Owners

- Funding Capital Needs Generally
- Venture Capital
- Initial Public Offerings
Funding Capital Needs

- Purposes
  - Working Capital
  - Growth
  - Redemption of stock or debt
Funding Capital Needs

- Types of funding
  - Debt v. equity
    - Debt is less risky for the holder
    - Holder is willing to accept less return on debt in favor of greater certainty of repayment
    - Fewer restrictions on holders of debt in an S corporation
Funding Capital Needs

- Debt - "notes", debentures", "bonds"
  - Payments - interest only or principal and interest
  - Fixed terms or on demand
  - Variable v. fixed interest rates
  - Subordinated debt
  - Interest is deductible
  - Business owner preserves control
Funding Capital Needs

- Equity
  - Interests in company - common or preferred stock
  - Partnerships and LLCs
    - Issue different classes of partnership or membership interests
  - S corporations
    - One class of stock, different voting rights
Funding Capital Needs

- **Equity**
  - **Preferred Stock**
    - May forego participation in company growth in favor of fixed earnings through dividends
    - Convertibility
    - Anti-dilution
    - Participating preferred
    - Redemption
    - Voting rights
  - Equity offerings attractive in lieu of debt payment obligations
Funding Capital Needs

- Blended debt and equity
  - Convertible debt, warrants/options
    - Lower interest rate on convertible debt
    - Higher conversion price
  - Convertible preferred stock
  - Redeemable preferred stock
Funding Capital Needs

- **Warrants**
  - Rights to purchase stock at fixed price
  - Supplemental agreements
  - May be traded or transferred separately
  - Funds on exercise/discount stock prices
  - Similar to convertible security
Funding Capital Needs

- Mezzanine - "Bridge Financing"
  - Short-term financing
  - Often used as interim financing with IPO
Funding Capital Needs

- Sources of funding
  - Banks
  - Insurance Companies
  - Individuals
  - Venture Capital
  - Public and Private Offerings
Venture Capital

- Excellent source of funding for growing business
- Invest in company’s equity, preferred stock, or convertible debt
- Money available from variety of sources
Venture Capital

- Selecting a venture capital firm
  - Company must consider:
    - Advantages of involvement on the board
    - Experience in the industry
    - Vision and potential to assist with strategic thinking
  - VCs specialize in a particular industry
    - Can offer strategic advice and expertise
Venture Capital

- Selecting a venture capital firm
  - High-profile VC
    - Provide industry contacts
    - Provide sources for management, strategic partners, positioning, and financing
    - Stamp of endorsement for subsequent investors
Venture Capital

- Two specialized types of VCs
  - Small Business Investment Corps.
  - Specialized Small Business Investment Corps.
    - Borrow from Small Business Administration
    - Invest in minority-owned companies
    - Smaller investments than a typical VC
Venture Capital

- Must thoroughly evaluate the VC
  - Analyze contributions outside of financial
  - Must be knowledgeable of business
  - Look at their investment portfolio
  - Find out competitors/industry contacts
Venture Capital

- Downside of venture capital financing
  - Structure and documentation extensive and intimidating
  - Thorough due diligence, intensive financial projection and business planning
  - Aggressive negotiation of operating and control issues
Venture Capital

- Downside of venture capital financing
  - Loss of control over board of directors and management decisions
  - Compensation arrangements with disincentives for the company missing plan targets or not reaching growth projections
Venture Capital

- Downside of venture capital financing
  - Quick turnaround of investment
    - Available exit strategies
      - Going public ("IPOs")
      - Selling to a larger company
      - Buying out the VC for cash
- All terms should be reviewed by an attorney before signing
Venture Capital

- Mechanisms for control by VC
  - Anti-dilution rights
  - Call and put
  - "Tag along" and bring along" rights
  - Rights of First Refusal
  - Registration Rights
  - Board composition rights/vote requirements
  - Supermajority voting provisions
  - Restriction on management
Current Trends in Venture Capital Financing

- Current Deal Terms
- Down Rounds
- Employee Ownership Issues
Current Trends in Venture Capital Financing

- Longer Lead Time
  - To funding
  - To exit
- Importance of revenues and profitability
- Management experience paramount
- Syndication of A rounds
  - Regardless of size
Current Deal Terms - Terms Designed to Increase Returns

- Reduced valuations
- Tranche funding on milestones
  - Monitors downside protection
  - Improves IRR
  - Challenge of clarity of milestones
  - Enforcement of closings
Current Deal Terms - Terms Designed to Increase Returns

- Founder vesting
  - Longer periods
  - On conversion and liquidation

- Participating preferred
  - Multiple of investment
  - No cap
  - On dividends
  - Eliminates need for election on conversion
Current Deal Terms - Terms Designed to Increase Returns

- Adjustment to conversion rate
  - On IPO, no change in control
  - Minimum IRR
- Mandatory cumulative dividends
  - Cash or stock
- Full ratchet antidilution
  - Compromise for a period (through another round)
  - Deferred weighted average
Current Deal Terms - Terms Designed to Increase Returns

- Greater than pro-rata rights on follow ons
- Convertible debt as A round
  - Partial funding (first milestone)
  - Bridging to second institutional round
  - Secured; subordination
  - Discounted participation rights in later round
Current Deal Terms - Terms Designed to Increase Returns

- Warrant coverage
  - Variable pricing; next round discount
  - Toxicity if no forced exercise
  - Purchase price allocation (between note and warrant)
  - Effect of warrant on dilution calculation
Current Deal Terms - Terms Designed to Increase Returns

- Increasing option pool in pre-money valuation
  - Shifting deferred dilution
- Earlier redemption rights
  - Original price vs. FMV vs. liquidation return
  - Inclusion of cumulative dividends
  - Statutory limitations on redemption
Current Deal Terms - Control Rights

- Pay to play in syndicate
  - Convert to common if fail to participate
  - Lose protective provisions (including antidilution)
  - Accords additional antidilution protection
- Expanding protective (approval) provisions
  - Negative covenants
  - Operations (cash flow) monitoring
- Board control
  - At minimum, control on default, covenant violation
Current Deal Terms - Control Rights

- Class voting on protective issues
  - Separate A lead approvals
  - Supermajority vote
- Founders personally on representations
- Forced change in control
  - Control of sale as form of liquidation
- Co-sale rights covering all stockholders
- Drags
Current Deal Terms - Other Issues Presented

- Effect on antidilution calculation
  - Infinite regress - never ending internal calculation
- IRC Sec. 305
- Overhang
  - Effect of Series A economics on later raise
  - Old LBO flavor of securities with strips of rights
Down Round Challenges

- Wonderful nomenclature
  - Salvage round - restart - washout
- Hosing (down) the unwashed classes
“Extreme” Down Rounds

- Enhanced scrutiny unless protective measures are in place
  - Market check of terms
    - Solicitation of bids
    - Auction process
  - Avoiding exclusivity
- Exploring financing alternatives
  - Sale; liquidation
- Financial advisor, fairness opinion, appraisal
"Extreme" Down Rounds

- Use of disinterested Directors
  - Special Committee
- Role of disinterested new investors
- Stockholder approval
- Record of advice, evaluation and deliberation
- Minority participation
  - Speed of restart
  - Rights offering - barring minority claims
  - Mitigation of conflict of interest
“Extreme” Down Rounds

- Next round pricing strategy
  - May avoid fiduciary duty challenge but what if no next round?
  - Most VCs willing to adopt such strategy
    - Either common gets diluted or they don’t invest

- Cram down eliminates preferences, rights (antidilution, etc.)
  - Reduce protective provisions of new class

- Indemnification
Effect of Down Rounds on Employee Ownership

- Management retention
  - Disincentive of onerous liquidation preference
- Creation of performance based restricted stock pool
  - 83(b) elections vs. option approach
Effect of Down Rounds on Employee Ownership

- Preferred Stock Option Grant
  - Same economic benefit as down round investors
  - "Preferred like" economics not control rights
  - Challenge of "repricing" analysis (canceling prior grants)
  - Acceleration triggers
Effect of Down Rounds on Employee Ownership

- Retention and bonus strategy
  - Milestone compensation
  - Acquisition payout
    - Deal price formula
    - Parachute avoidance
- Variable accounting challenge
Advantages of an Initial Public Offering ("IPO")

- Ability to raise additional capital
  - Expand facilities, develop new products, increase marketing activities, and explore new markets
  - Permit expansion through stock for stock acquisitions
  - Improve balance sheet -- reduce debt/equity ratio, improving company’s ability to borrow money
Advantages of IPO

- Provide relations and marketing advantages (higher profile, prestige, enhanced credibility)
- Ability to create employee incentive programs that readily link corporate performance to compensation
Disadvantages of an IPO

- High initial and recurring monetary cost
  - Company must pay underwriters, attorneys, public accountants, printers, transfer agents, and the stock exchange upon which the shares will be listed
  - Periodic filings required by the Securities Exchange Act of 1934 to keep the public informed about company developments
  - Company must comply with proxy solicitation rules, and prepare an annual report to stockholders
  - Stringent internal financial controls required of public companies by the Foreign Practices Act
Disadvantages of an IPO

- High cost in executive time
  - Preparation of offering can take three to six months during which corporate executive staff must spend time working with investment bankers, attorneys and accountants
  - Recurring demands on executive time to prepare periodic reports after IPO and for shareholder relations
- Directors and Officers liability insurance becomes more expensive
Disadvantages of an IPO

- Reduced flexibility
  - Salaries, expenses, dividends and benefits become a matter of public record and are judged by public-company standards
  - Decision process slowed due to participated of public owners
  - Board answerable to public shareholders rather than small ownership group
  - Pressure from shareholders to maximize short term result and pay dividends
Disadvantages of an IPO

- Increased legal exposure to liability under securities laws (e.g., obligation to make accurate disclosures to the public of material information)
- Sarbanes-Oxley and related considerations
  - Certification of SEC filings
  - Criminal penalties
  - Prohibitions on loans
  - Independent Board members
  - Audit committees
  - Forfeiture of executive bonuses and profits
Disadvantages of an IPO

- Loss of privacy
  - Insider transactions (i.e. executive salaries, loans, leases, property sales) become public knowledge or, under Sarbanes-Oxley, prohibited
  - Public Disclosure documents reveal company’s financial statements

- Exposure to takeover attempt. Once stock is publicly traded, it may be possible for investors to purchase enough to take control
Certain Planning Issues Preceding IPO

- Corporate "housekeeping"
  - Articles of incorporation; bylaws; stock ledger; minutes of meetings of directors and stockholders; qualification to do business in all necessary states
  - Stockholder and director approval of certain matters (stock issuance, appointment of officers and approval of interested party transactions)
  - Check that pervious issuances of stock made in compliance with state corporation laws
Certain Planning Issues
Preceding IPO

- Compliance with federal and state securities laws (check whether outstanding stock issued in compliance with securities laws)
- Other legal compliance check -- antitrust, commercial, environmental, intellectual property, labor and tax
Certain Planning Issues Preceding IPO

- Simplification of the Company's capital structure
  - Plan to grant options and warrants only in special circumstances
  - Do not issue promotional shares to promoters, directors or officers at prices far below expected offered price ("cheap stock" and SEC accounting issues)
  - Negotiate automatic redemption or conversion of convertible preferred shares of common stock, effective in connection with the IPO
Certain Planning Issues Preceding IPO

- Accounting statements and practices
  - Audited financial statements are required for registration statement
  - Must comply with SEC Regulation S-X and GAAP
  - Must be prepared by an independent, certified public accountant
  - Accounts must give opinion as to the "fairness" with which the statements are presented
  - Acquisitions -- may need audited financial statements for acquired companies
  - Pro forma information for major transactions (asset sales, mergers, etc.)
Certain Planning Issues Preceding IPO

- Insider transactions
  - Related-party transactions for previous three years will have to be disclosed on registration statement
  - Consider appearance of conflict of interest of related-party transactions and whether documentation is needed to justify that transaction as arm’s length
  - Approval by disinterested directors
Certain Planning Issues
Preceding IPO

- Review of material contracts (e.g. possibility of defaults, change in control provisions, prohibitions on stock issuances, exclusive dealing contracts, registration rights of existing investors, etc.)

- Review executive and employee compensation
  - New employee benefit plans
  - Review director and officer insurance policy and indemnification arrangements
Small Business Initiatives

- SEC has adopted rules aimed to target small businesses which are intended to lessen the burden on them - can’t have revenues of more than $25 million or a “public float” of more than $25 million in order to be eligible