VCEXPERTS™ The Competitive Edge in Private Equity & Venture Capital

Are Standard Venture Capital Financing Rounds Up To Speed With The Latest Trends For Going Public?

Peter Sugarman, of Yigal Arnon & Co.

The National Venture Capital Association (www.nvca.org) publishes a benchmark set of model transaction documents that are commonly used or referred to in venture capital deals worldwide. The current model certificate of incorporation contains the following provision regarding mandatory conversion of preferred stock into common stock:

> "Trigger Events. Upon either (a) the closing of the sale of shares of Common Stock to the public at a price of at least $[_____] per share (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to the Common Stock), in a firm-commitment underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, resulting in at least $[______] of [gross] proceeds [, net of the underwriting discount and commissions,] to the Corporation or (b) the date and time, or the occurrence of an event, specified by vote or written consent of the holders of at least [*specify percentage*] of the then outstanding shares of Series A Preferred Stock (the time of such closing or the date and time specified or the time of the event specified in such vote or written consent is referred to herein as the "**Mandatory Conversion Time**"), (i) all outstanding shares of Series A Preferred Stock shall automatically be converted into shares of Common Stock, at the then effective conversion rate and (ii) such shares may not be reissued by the Corporation."

The language above is a fine example of a standard deal term whereby all classes of preferred stock convert into common stock prior to an initial public offering. This provision reflects the fairly common practice of registering and issuing one class of stock to the public upon an IPO. It is also designed to minimize the corporate consents required for a company with multiple investors from different stages and different classes of stock, to go public.

However, in view of recent headlines and recent offerings in the technology sector, we question whether this is still the best practice for both founders and investors. Google recently made headlines with an announcement that it is planning on splitting its shares and creating a new class of shares without voting rights. In addition, fairly recent high-profile IPOs of internet/technology companies like Zynga and Groupon demonstrate a trend of going public with a dual class or multi-class capitalization structure. Facebook's pending IPO is apparently also structured in a similar way designed to preserve control in the hands of the Company's founder, Mark Zuckerberg.

In the case of both Groupon and Zynga, as stated in each respective prospectus, the companies carried out a recapitalization, adopted a new charter prior to the IPO and created these new classes of shares and structures. When a company's IPO is greatly anticipated and pre-offer valuations are very high, stockholders are likely to be willing to adopt such structures at the behest of the founders and management. However, in other situations or where an underwriter is concerned about floating inferior (i.e., non-voting) stock, stockholders may be more reluctant to go this route. Accordingly, founders who desire to ultimately take their company public and continue to manage and control it for the long run may want to consider including appropriate mechanisms already from the early financing rounds to facilitate pre-IPO multi-class structures. Many practitioners will testify to the precedent effect, namely the ability to repeat in later rounds of financings the mechanisms and balances reached in the first or second round of financing. One could argue that by doing so an early stage company would be getting somewhat ahead of itself. However, as evidenced by the constant of mandatory conversion provisions like the one quoted above as well as registration rights agreements executed as part of the first rounds of financing, it is clear that the industry already seeks to facilitate an IPO (or other exits) from these early stages.

Peter Sugarman, Partner in the Israeli law firm, Yigal Arnon & Co., peters@arnon.co.il

Peter represents a variety of clients across a full range of activity in corporate and commercial law. Mr. Sugarman's practice includes representation of venture capital funds and private equity investors as well as technology companies receiving venture capital and other funding. In addition, he works closely with founders and executives of emerging growth companies, providing strategic legal advice and general corporate representation, including in the fields of intellectual property, branding and corporate partnering. Among his clients are companies in the social media and e-commerce space, semiconductor developers, mobile and cloud computing companies. He has worked with a number of his start-up clients from inception to their sale, in addition to working on complex M&A transactions, including forced sales and leveraged buy-out.

Yigal Arnon & Co.

Established over fifty years ago, Yigal Arnon & Co. (http://www.arnon.co.il) is one of the largest and most dynamic law firms in Israel, with a proven track record of innovation and quality in meeting its clients' needs. Yigal Arnon & Co. today numbers over 120 lawyers, of whom over 40 are partners. With its focused practice groups, Yigal Arnon & Co. has combined the expertise of a specialty boutique practice with the advantages of a well resourced multidisciplinary law firm.

Yigal Arnon & Co. provides a full range of legal services to a wide ranging client base, including major international ("Fortune 500") and other global companies, local and foreign banks, financial institutions, venture capital and private equity funds, emerging growth companies, investor groups, government entities, and individuals. The firm represents clients in a wide variety of industries, including information technology, energy (including solar power and cleantech), banking, software, electronics, semiconductors, pharmaceuticals, biotechnology, internet, medical devices, real estate, telecommunications, insurance, automotive, and consumer products.