Lowenstein Sandler's Emerging Companies, Venture Capital Podcast: The Founder’s Hour

Episode 5

Laura Cicirelli and Eric Weiner

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Eric Weiner: Hi everybody. Welcome to The Founder’s Hour. From idea to exit happy hour conversations on forming, growing and Selling a Business, a Lowenstein Sandler podcast series. I am Eric Weiner.

Laura Cicirelli: And I'm Laura Cicirelli.

Eric Weiner: And we're partners in Lowenstein’s Emerging Companies and Venture Capital Group. Whether you're forming your first company, negotiating your first term sheet, or preparing for an exit, the decisions you make early can shape your company's future.

Laura Cicirelli: Each month, we bring the conversations happening at our New York office to the broader founder and investor community, sharing practical, legal and business insights to help you navigate every stage of your company's growth.

Eric Weiner: Welcome back everybody. On today's episode, we're going to talk about the company's first equity financing. So up to this point we've talked about forming the company. We talked about raising some debt. We talked about raising some money via safe or a convertible note. We talked about dilution. And now, we're at the point where we're going to be talking about, okay, it's the first time the company is taking money in for equity.

Typically, what we'd see would be a preferred stock financing.

Laura Cicirelli: Yeah, and before we even step into the logistics of that and the different terms that are negotiated in connection with the priced round, I think it's important to just step back at a high level view, kind of what are the documents that are involved here. And we're not going to go through each of the documents, but I think it's important to note that with a convertible round we talked about, especially with this safe, it's a simple agreement for future equity.

You're looking at something that's four pages long. Here, you're going to get a robust a robust set of documents. You're going to get, if you're using the National Venture Capital Association's documents, you know, an amended and restated charter, a stock purchase agreement, and then some shareholder agreements, but there are different forms that can be used as well.

So, we're not going to go into excruciating detail.

Eric Weiner: Yeah, I mean, I think the main point is that you do a safe financing, it's a 4- or 5-page document and you're done. In equity financing, that 4 or 5 pages becomes 150 pages, and you know, the real benefit, like we discussed when we talked about safes and convertible notes is, those transactions are a lot simpler to do.

You really are only thinking about the economics. When you get to this financing, the priced round. Okay. Now you're talking about economics. You're talking about governance. You're talking about stockholder rights. You get into negotiations that you don't need to get to, which is why you go from five pages to 150 pages.

Laura Cicirelli: Yeah. And because you are now going to actually issue this investor preferred equity in your company, there's going to be diligence done that a lot of times is not done in connection with a convertible round.

So, you're looking at a longer timeline for that as well. So, something that for a safe, you could do maybe in a few days for this, you're looking at 30 to 45 days because there's a lot more to draft, and on top of it, they're going to be digging into the company a bit and looking at documents you have, as far as share issuances over time, employee documents, all of that stuff.

Eric Weiner: Yeah, I think that's a great point. You negotiate a term sheet for a price round. The first thing that happens after that term sheet is signed is, there is a lawyers call between the company's lawyers and the investors lawyers, and right after that, the investors lawyers send a due diligence request list, which would require the company to set up a data room, kind of all of their information, and yes, in a safe, there's 4 or 5 reps and warranties in the purchase agreement for equity financing. Multiply that by five, and you're going to have to have a roadmap of diligence and things like that. A much more involved transaction.

Laura Cicirelli: Yep. And the other point before we dive in is this is going to be the basement of the house. I think we use that analogy a lot when we talk to our clients, in that over time, this is your first round of financing, but when you have the second round, so this is your series seed. When you have your series A, it builds on the documentation for your series seed.

And once you have something in those documents, it is very difficult to get out. So, when early investors get it right, later investors are going to want to get them. So, when you are negotiating a term sheet, please keep that in mind. And, if you think, “Eh. I'm fine giving it just in this round,” you're not giving it just in this round. You're giving it in this round and the future rounds, because it's very difficult to take something out.

Eric Weiner: Cannot underscore that point more. This is a precedent setting financing. It’s your first equity financing. What you agreed to today, you are effectively agreeing to forever… because it is, like Laura said, much harder to remove a right from a document, even if it's the right thing to do later, than put something in. So, basement of the house. You want that foundation to be solid.

You really… When you are negotiating your first equity financing round, you want to be thinking not about only about that round, but all the future rounds that happen later. Because, if you set your foundation up right or as well as you can, you're hopefully going to be able to rely on what you did in the beginning for the rest of your fundraising life.

Laura Cicirelli: And the last point I'll say about that as well is, if you think, “well, let me try to keep it out of the documents and put it in a side letter for an investor.” Just be cognizant of that as well, because in diligence and in future rounds, side letters are going to be reviewed. So, if you think you're giving a right under a side letter that no one's going to see or ask for in the future, just be cognizant of that. It will certainly be diligenced.

Eric Weiner: We do hear from time to time. “Yeah. Just put it in a side letter.” No. No. No. Everybody sees the side letter. It doesn't matter.

All right I think we should start. I mean, the first thing and probably the issue that founders and investors think about the most when they're doing a financing, a price round, is the economics, right?

Eric Weiner: The economics are really critical. But as we get further along this podcast, you'll see there's other things that are almost as important. So, we talked about pre and post money a little bit in our last podcast. Here is where you're going to get someone's going to make an offer for to invest in the company.

In this case we're going to use someone's going to say, I'm going to give you $5 million on a $50 million post-money. That's 10% of the company, 5 over 50. But what are investors looking to get for that?

Laura Cicirelli: Yeah. So, we talked about in the last podcast, kind of the dilution to the existing cap table. What does that mean as far as post-money, pre-money? So, we won't go into that too much. But you know, when this company sells, and now we have something called preferred stock, versus the common stock that the founders have, what does that mean, in what you often hear as a waterfall? So how are the preferred protected in a sale event above the common stock.

Eric Weiner: Yeah. Most times when we're doing an initial round of preferred equity financing. Investors get a very basic convertible preferred stock. And what that means, in the most basic terms, is when the company is sold, the investors get, using the $5 million on a $50 million post-money example, the greater of their $5 million back, or 10% of the proceeds in the transaction.

So, if you think about it, if you're an investor, you don't want your $5 million back. You're hoping to get your 10%, because if the company is sold for $1 billion, I want $100 million. I don't want $5 million. That is pretty much the liquidation preference that Laura and I see in early-stage equity financing.

Laura Cicirelli: Yeah. And keep in mind, when we say 10%, that's just based on assuming that you get your equity and nothing else happens to the cap table between, you know, the series seed and a sale, which is likely not to happen, but we're just using that for simplicity purposes. You're diluted in the same way.

Eric Weiner: If the company was sold a month after you did this equity financing, but there's future financing, everyone's going to be diluted, including the investor’s10%.

Laura Cicirelli: Yeah. And so, what Eric just described is what we usually call a “1x non-participating” preferred. So, if you hear that shorthand or you see it, it's often written in terms sheets like that very short handed 1x liquidation preference. That is what it is. It's 1x your money that you put in, so your money back essentially.

Eric Weiner: It's greater of, the 1x, or your percentage ownership. Yes.

Laura Cicirelli: But if you saw 1.5x, that is going to be 7.5 million instead of the 5 million in Eric’s example.

Eric Weiner: Correct. And that is not common in early-stage venture financing transactions. So, if there is a deal and someone is asking for a multiple liquidation preference greater than 1x, or from time to time we see something called participating preferred stock, which we'll talk about in future podcasts when we talk about sort of recaps and distressed financings, that is something that should raise some eyebrows at the early stage.

And just for a very quick explanation of what participating preferred is, instead of investors getting the greater of their $5 million or 10%, if it was participating preferred, they would get their 5,000,000 first and then would split the remaining proceeds 10% / 90% to the rest of the cap table. So, you get your money off the top and then you get to participate as well.

That is not common at the early stages. It is not common generally, but you could see it and we do see it at later stages.

Laura Cicirelli: Yeah. Or distressed situations where the investor has tons of negotiating power and the company just needs to get money in the door.

Eric Weiner: And in that case, the investors saying, “look, I'm bailing you out, like this is, you know, we're hoping there's an upside to ride here, but there may not be. So, for me to de-risk this very risky money, I need something better than what the traditional non-participating preferred is.” But at the earliest stages, the investors do not want their preference. They want their 10% because this is early. They want to grow. They want to ride the upset.

Laura Cicirelli: And going back to our basement of the house conversation we had at the beginning; they don't want it now because it's not necessary. This isn't risky money in the same way of Eric's example of a later stage company. And if I'm getting it, the series A is going to ask for it, B, and

I'm just going to, you know, it's not going to be good for me at a sale event when I have all this other preference above me.

Eric Weiner: 100%. And if you think about it, last thing we will note on the basement of the house, and also like there's a shared risk. This is the highest risk, highest reward time for someone to invest, is if the company succeeds. If you do around at my $50 million posts that I said and the next round is $250 million or $200, the early-stage investor is way in the money.

They're kind of treated like the founders. They don't need the downside protection anymore. But if you raise your first round of equity financing and the company fails, you know, a million different protections don't really mean anything. But if you go if you do too much and we'll get into governance and the other rights in a minute, you're basically giving the later stage investors a negotiation tool to get better rights for themselves that they might not even ask for in the first place.

So again, foundational round.

Laura Cicirelli: Yeah, absolutely. So, before we go on to the next topic, which I think is going to be governance, where we'll spend most of our time on this podcast, I think there's two important things to talk about with price and preference in general economics.

One is dividends, and we don't usually see accruing dividends. I think it's very, very rare to see that in a term sheet. But it is important to note that if you see that, what does that mean? That means that the shares, a preferred stock, have dividends that are accruing under them over time. So, when you have the liquidation payout at a sale event, in our example, Eric's the greater of the 1x or 10% of the company for that downside, protection of the 1x is actually not just your money back, but it's your money back plus, anything that's been accruing over time. So just keep that in mind that that 1x is actually a little higher.

Eric Weiner: Well, what I'd say is, there's different flavors of dividends. Most times we see no dividends, and by the way, startup companies don't ever issue dividends okay.

Laura Cicirelli: What you just see is that if we do declare dividends the preferred will get them before common.

Eric Weiner: But they never do. I mean, they're going public when they're issuing dividends. Sometimes we see a certain percentage dividend when, as and if, declared by the boards, assume it's 8%. Again, boards never declare a dividend and in my 25 years of doing this, I've seen a dividend once. It was the second week I was a lawyer.

Accruing dividends, if it was the same 8% accruing dividend, what Laura was explaining is, you have the 1x liquidation preference we talked about, the greater of your one times your money or your 10%. If there's an 8% accruing dividend every year, the preference piece would go up by 8%. So, after year one it would be a 1.08x preference or 10%.

After year two it would be a 1.16x preference or your 10%. If it was a compounding dividend, it would go even higher. But that is, we do see that maybe 10 to 15% of the time. But most often in startup companies we do not see accruing dividends or any dividends. But if you see an accruing dividend, that's when you want to focus on a little bit more, because it does increase the investors' downside protection in the deal.

Laura Cicirelli: Yeah, absolutely. And then the second point is just anti-dilution protection. So, we did talk about the 10% ownership that you have, and that's not going to stay the same over time, between now and a sale event, if the company issues more equity. But there could be adjustments to the conversion ratio. So, at the time of this issuance usually preferred stock can be converted to common stock on a 1 to 1 basis.

Eric Weiner: That's the 10%.

Laura Cicirelli: Yes, and so that's very standard for it to be a 1 to 1 basis. But that conversion ratio can be adjusted over time. If the company starts to issue tons of equity at a price per share lower than what the investor paid, and they want to get that protection that, it's not going to be a full ratchet anti-dilution.

I don't want to go into too much detail here about that. It's some type of formula where it's taken into account to adjust the conversion ratio, but it's not like you're going to stay at 10% forever.

Eric Weiner: Any dilution is hyper complicated in a term sheet for your equity financing. On the company side, you're going to see something called broad based weighted average anti-dilution.

Laura Cicirelli: Very standard.

Eric Weiner: Yeah. Laura did mention full ratchet. And you know, pre-2010 used to see full ratchet quite a bit. But effectively what it means is, and this is just that 10% piece of the liquidation preference we were talking about, but if we did our financing at $1 per share and the next round was at $0.90 a share, if it was broad based weighted average anti-dilution protection, the investors in our round, the $1 round, would get an adjustment to make it as if they invested something between $0.90 and the $1. Probably very close to the $1.

If it was a full ratchet anti-dilution, they would get an adjustment to be as if they invested at $0.90. So, it's a much more impactful adjustment. But hopefully you never have to worry about this, and you just see broad based weighted average, and you move on.

Laura Cicirelli: Yeah, I think that is incredibly standard for that to be the adjustment form. The one thing that will get negotiated a little bit, not tons during the drafting stage, will be, "well, what are the carve outs for issuances that could be below my price that wouldn't trigger this." So, things like if you want to incentivize employees and issue them common stock at a low exercise price, things like that is not going to be something that triggers this, right?

Eric Weiner: And they shouldn't, and we'll talk about this in the next podcast when we talk about hiring and all that stuff, but definitional, you know, options that companies give to employees and other service providers have a price per share that is almost automatically lower than the preferred. If it was the same price as the preferred, this would be a public company.

Laura Cicirelli: Absolutely. So, I think those are really the points that we wanted to talk about when we deal with economics in a term sheet. Now we're going to turn to governance, which is really the rest of what you're going to be negotiating. And incredibly important at this point. It's been you or you and your co-founders really controlling the company, whether that be through your ownership percentage of the company or in the boardroom.

And now this is the first time, really, we're going to welcome other people as directors, and there's going to be other people on the cap table who are going to have certain types of voting rights as far as, you know, shareholder rights. So we'll talk about those.

Eric Weiner: Yeah. To me, I believe this is really where the rubber hits the road, on the negotiation of priced round. A lot of the other rights will get to towards the end of very, very standard in that there's not a lot of negotiating negotiation around them. They kind of are what they are. There's some stuff on the edges. Governance is really critical.

And I think Laura framed it really well. Founders have had control of the company. You know, anything you want to do, you can kind of do. And then you take money, which is an amazing thing, but with that money comes certain controls, whether those are positive controls like forcing things, which is very, very rare or more commonly, negative controls.

There's like, okay, now there's certain actions that the company will not be able to take without the approval of the preferred investors. And there is a suite of these, let's call negative controls, that are very customary in these financings. We could talk about a few, but the thing that is the biggest part of the negotiation in our experiences.

Well, who has the negative controls, or what's the threshold for those controls? Is it a majority of the preferred? Is it just a particular investor, and this is one of the foundational basement of the house issues that we were talking about in the beginning.

Laura Cicirelli: Yeah. I think we divide this up into kind of two baskets, board composition and what goes on in the boardroom and approvals there. And then on the shareholder side, those protective provisions that Eric was alluding to, you know, what do we usually see there? And I think it's important to note for founders before we dive into it, that investors are not trying to put money into your company to run the day-to-day operations of the company. That's not what they want to do.

They're investing in you because they like the business you've built, and they trust you, and they want you to continue doing that. And I don't think that you need to be fearful that, “oh my gosh, now, before I do anything, before I sign any contract, I need to run it by my board or the preferred shareholders." That's not what they're trying to do here.

But for major decisions like selling the company or, you know, issuing certain stock that may have a preference above theirs, for example, they want to have some control over it, or just have a say in it and make sure that they're aware of these big decisions that affect their economics and the governance of the company.

Eric Weiner: And they're not wrong for that, but I think you framed it really well Laura, in that. Yeah. They believe in the founders, but at this stage of the company you might not have any revenue. You might have really nothing other than the idea that you're building. Maybe you're in the market, maybe you're not.

But the investors at this stage are really putting their faith behind the founder. But, at this point, okay, they are on your cap table. You have accepted money. So, there's board rights that I think Laura was about to talk about, and stockholder rights. And I think, Laura, we should probably talk about, you know, the difference between board and stockholder and how things like that are set up.

Laura Cicirelli: Yeah, absolutely. So, for board composition, like we said, at this point in time, it's probably been just you, or you and some co-founders, and so now you're welcoming whoever the lead investor is. They're almost always going to ask for a board seat. And they want to sit in that boardroom. And usually, it's tied to some threshold of ownership, right?

They can't sell down their position by a huge amount and still maintain that right. So usually, we see something like 25% to 50% of the shares they purchase at the initial closing. They need to maintain ownership of those shares in order to be able to appoint someone to the board, but they will have someone that they can designate in that board seat.

And that's what we call a preferred director seat. And so, you will see a lot of times in the documents, now things that require board approval, it's not just the majority of the board, which is a requirement under Delaware law, but now we've agreed to a majority of the board, which must include that preferred director's approval as well.

Eric Weiner: Yeah. I mean, and those would be contractual, but there is, it could be the case where there's one founder and then one preferred director on the board after that, so that would be a majority. You would need unanimity in those cases. But you know, Laura's point as majority rules generally, I mean, it is very unusual to see a two-person board after these rounds, usually at the minimum, you would have three.

But yeah, I mean, regardless, you probably have not held a single board meeting up until this price round. You do a price round and now you've grown up a little bit. You're out of preschool and you're in kindergarten now, and you're starting to do things a little more formally, and you're going to start having board meetings and to get stuff approved, you're going to need to have a conversation about it and make sure that, you know, there's a there's alignment on it.

And it's a good function to have sophisticated people in the room talking about the actions that the company is going to take. But yes, no longer do the founders get to do anything they want, whenever they want.

Laura Cicirelli: Absolutely. And sometimes, you know, the lead investors almost going to always ask for a board seat. But sometimes you'll see other investors who may not be the leads, ask for observer seats, and kind of what are the differences between a director seat and observer seat.

So, directors get to vote, and they also have fiduciary duties to the company and its shareholders, and that they can't just say no to something and hold out on approvals just because they don't feel like approving it, or it's not of interest to them as a shareholder, Right?

Those are two separate things. They kind of have to put on their director hat when they have board meetings, and there's things that need to be approved where you have to do what's in the best interest of the company and its shareholders.

Eric Weiner: All of its shareholders.

Laura Cicirelli: Yeah, absolutely. And so that's why a lot of times we have the conversations with founders when it comes to a certain block, and if we want it to be a board level block in the term sheet versus a shareholder block, one of the benefits of pushing it to a board level block at the term sheet stage and in the documents, is that there's fiduciary duties tied to it, where you can just say, "I don't want this approved as a shareholder." There aren't fiduciary duties to the other shareholders. As a director, you can't just do that.

Eric Weiner: I think this comes back to, okay, so we were talking about the negative controls. Most of the stockholder level negative controls, and the reason why I was very clear in stockholder level is, to Laura's point, at the stockholder level, 99% of the time the stockholders can just say no. Doesn't matter why, it can be raining outside, and someone's upset. They can say no. They don't have fiduciary obligations to the company and its stockholders as stockholders.

As directors the board has fiduciary obligations. Any action they're going to be voting on, they have to consider everyone. So, most often what we see is that the preferred stockholders get negative controls on actions that impact their economics. So, for example, sale of the company, a future financing, things like that. Okay. If you do those actions in the future, it could have an impact on economics. Those are not generally operational types of controls.

There are also things that you may see investors ask for, like Laura calls them blocks, their negative controls are blocks, like hiring and firing of the CEO or executive team, issuing equity to certain people, you know, encumbering certain intellectual property. There's things like that that are more.

Laura Cicirelli: More operational than you'd see in the shareholder blocks.

Eric Weiner: And in those cases, what we do typically see, and we are talking about this from the founder’s perspective. So if we were negotiating this on behalf of a founder, we would be pushing those operational type of blocks into director level blocks because there, if the preferred director had the block, if the documents say “these things require the approval of the board, including the approval of the preferred director,” we would want to make sure that that director is considering those actions from a fiduciary perspective and can't just say no because he or she doesn't think it's in the fund's best interest.

Laura Cicirelli: Yeah, no, I think that's a great point. The kind of two baskets of things are negative controls. You can think of them more as more operational versus more economic. Economic makes sense for the shareholders to really have those blocks on rather than the directors.

Eric Weiner: For sure. And then I think, you know, what's really important because, look, there's generally a market suite of these blocks you don't really get in too heavy a negotiation about the blocks. Sometimes you do and hopefully you don't. But there's always some negotiation around these things. Basement of the house was what we discussed before. Now it's like, okay, “who has the block? What stockholders have the block?”

And again, from the founder's perspective, we're thinking, “well, majority rules is usually the easiest way to get this stuff done. So, future financing, who do I need to get to approve that future financing?” If we're representing the company, we're going to push that to likely be the majority of the preferred. Because if a majority rules, presumably all the preferred are economically aligned. They all came in at the same price. They're all going to have the same economic interest.

So, if the majority of those investors believe this is in the best interest and they want to approve it, that would be what we want. Sometimes you will see blocks that say you need a majority of the preferred, which must include “fund X,” or you need 67% of the preferred.

And where that gets a little scary from the basement of the house perspective is that once you have a threshold like that, you have that threshold forever. So, we do run in from time to time when you know you have no choice but to agree to a threshold like that. You know, company comes and says, “well, I want to raise a financing round. Who do I need to approve that?” And, you know, you'll need almost your whole cap table. It makes things more challenging and adds a little bit more friction to the transaction.

And usually, you know, look, your first round of funding on a price round. Generally, you're going to have a sophisticated fund, or multiple funds if there's co-leads or whatever, who are in the market, and they know how this works. Usually, it's not that much friction. But if you put a threshold that is unnecessary for this round in now, you're going to give people blocks later.

Laura Cicirelli: You're not decreasing it over time.

Eric Weiner: Right. And it seems like in those cases you could actually be negotiating against yourself a little bit. Because if the company succeeds and performs the early-stage funds probably don't want the later stage funds to have the blocks.

Laura Cicirelli: Yeah, absolutely. And named blocks. I know you mentioned it where we say, you know, 50% of the preferred, which must include XYZ fund… so dangerous. It's really important that if you can get those out and just work on maybe increasing the percentage threshold there as an alternative, that's definitely the better approach than naming people specifically that need to approve those.

Eric Weiner: I agree, it's exactly what I would do in those cases, but if you think if Laura Cicirelli Fund has “block” and then I come in later, I'm like, “well, Laura has it.”

Laura Cicirelli: And imagine if Laura then sells down her position.

Eric Weiner: Right. And I'm coming in at a higher valuation at a later stage. I want that.

Laura Cicirelli: Yeah, absolutely. So, finishing the thought over, you know, the difference between a preferred director and observer. Before we move on to the next topic that's negotiated; the observers do not vote while the preferred director does. And a lot of times you may think,” oh, if they're not voting, it doesn't hurt to just give them this right if it makes them happy.”

But you should be cautious about giving out too many observer seats, because they're still going to be in the boardroom, which means they're still going to have influence over the board. Right? They could still speak in the meetings. They can maybe persuade directors to vote a different way than they would have normally decided to vote. And I don't think it's a huge risk, but you don't want to overcrowd the boardroom.

Eric Weiner: At an early-stage startup company, you have 18 people in the room. It's just not efficient.

And like we're about to go into stockholder rights and we're going to talk about the difference between sort of like a regular investor and a major investor. An observer right belongs to someone who writes a real check. Someone who's writing a tiny, tiny little check that’s going to be a half of a percent or a percent of your cap table. Just because they asked for it doesn't mean they get it. You got to earn that observer seat, just like you got to earn the board seat.

Laura Cicirelli: Yeah, absolutely. And so that's a good segue into major investors, and what are some of the rights that you see in the documentation for those who write real substantial checks?

Eric Weiner: Yeah, I mean, we've now talked about economics. We talked about governance. We talked about those for a long time. Because truthfully, those are the things that are negotiated the most and we believe are the most important. Most of the stockholder-related rights that we see in these agreements are very standard. There's pro rata rights, and information rights, and refusal and co-sale rights and...

Laura Cicirelli: Inspection rights.

Eric Weiner: Yeah. Registration rights. All these different things that are very standard. Everybody sort of understands... both the investors and the companies, over time, understand exactly what these mean. But some of them, like **pro rata** rights, for example, information rights, these are real things, like pro rata, you want to make sure it's given to investors that can actually continue to fund the company over time.

Information rights, you know, sophisticated investors who need that information for their fund purposes makes total sense for them to get them. But if you have a round of 35 investors, some of them are giving you $25,000 checks when there's investors writing $4 million checks, giving it to everybody makes it challenging, so you typically see a delineation between major investors and investors.

And most often in these financing rounds, these price rounds, major investors get pro rata rights. Major investors get information rights.

Laura Cicirelli: Yeah. Like you said, the rights are not what's negotiated, right? You'll even see it as sometimes a line in a term sheet that says “major investors are entitled to standard pro rata, inspection, and information rights.” It's not very... It's very customary and market and accepted as market. But the thing that is really... negotiators should be thought about is what makes you a major investor.

And a lot of times that threshold will put in the be put in the term sheet. It has to be someone who's investing at least $1.5 million, $2 million, depending on what the round structure is. That will really drive who the major investors should be. But to Eric's point, it should be a number where it makes sense. It's not everybody. It's not 50%. It's really limited to those who are writing substantial checks based on science.

Eric Weiner: They're sophisticated market playing investors, right? Who understand how all this stuff works and are generally not going to bring too much friction into the process. You know, back to the whole sort of thing that we were talking about thematically on governance and stuff like that. You're no longer in control of your own destiny. You've taken money. So, the goal is to have the most sophisticated people be the decision makers on a go forward, so that when the company does things in the future, there's less friction.

As long as it's reasonable, it's easy to get done. You don't have to get consent or signatures or from every single cat and dog on your cap table.

Laura Cicirelli: Yeah. I mean, to Eric's point, you'll have, you know, if you ever want a waiver of these things, you need to go and get a majority, usually, of those major investors, or the shares held by major investors. And if you have to go and get 30 different signatures every time you need a waiver, it's not efficient. And also, you know, for information rights, for example, if you're delivering financials to the major investors, you don't want to have to go and send it out to 30 people. If you can limit it down to five, that's way more efficient for the company.

Eric Weiner: Exactly. It becomes a burden on operating the business, and the lead investors want you to operate the business. They want you to not worry about having to send quarterly financial statements to 35 people.

Laura Cicirelli: Yeah, absolutely.

Eric Weiner: And Laura, you just mentioned majority to waive, but the same thresholds that we were talking about in the governance… You are going to have to get waivers of pro rata rights. You're going to have to amend the transaction documents that we're negotiating now. We negotiate the thresholds to amend those documents, to waive **pro rata** rights, to waive stockholder rights, amend them…

It's part of the negotiation, the same way that the governance rights is. So, even if you've come to an agreement on governance that you are all comfortable with, the same thresholds should apply to stockholder rights. Yeah. Because if they don't, it's a backdoor block to doing anything anyway. You want to be able to get the same, or if you're dealing with just major investors at a stockholder level; at the stockholder right level rather, maybe it be fewer people, actually. But the delineation between major investors, investors, and critical, and the thresholds to amend or waive these rights is also critical.

Laura Cicirelli: Having a majority is definitely in the company's best interest. It's standard.

Eric Weiner: We did speak about stockholder rights very quickly, but the standard rights really are information and inspection rights, pro rata rights, refusal and co-sale rights, and by the way, those mean that if holders of common stock want to sell, usually have to offer them to the company first, the investors second, and again, we'd probably limit this to major investors. And if everybody says no to that, which they usually do, there are co-sale rights, which means the investors, the major investors in this case, could sell along with the holders of common stock on a pro rata basis.

Not a very heavily negotiated thing. It's very standard.

Laura Cicirelli: It's a way to keep the cap table tight and not to just have random people come on, if we can avoid it.

Eric Weiner: Right. And the reason why we kept it, sort of a short piece of the podcast is that it's kind of a short piece of the negotiations at the end of the day. There are a few other things or things called registration rights, which we'll talk about for very, very, very quickly, which just basically means that if the company is ever going to go public, there's something called a pre-IPO demand right, which means the investors can force the company to go public after a certain period of time, like five years.

Laura Cicirelli: You should avoid that.

Yeah, or post-IPO registration rights, which means after the company has decided to go public. It goes public; the preferred gets to participate in the offering on some level. On the company side, we do try to push for post-IPO registration rights, because I don't think any preferred investors ever forced, or been able to force a company to go public, but it could give the investors certain rights in the event that they want to demand it, and the company can't go public.

But that is the only thing you should ever discuss on reg rights, and otherwise it's 15 pages in the document you don't ever really need to read.

Laura Cicirelli: 100% right. Now just to kind of wrap things up, we'll turn to the founders, and we've talked about major investors and what rights they have, but what about the founders here? What does it look like for them after this round, and these documents are in place? What kind of flexibility do you have over your shares to either sell them to vote them? What does that look like?

Eric Weiner: I mean, you have less flexibility. Look, when we talked about formation, very typically if there's a multiple founder company, they should vest, both because of their interrelationship with each other and also because when you get to a price round, your first price round investors are investing in you for the most part.

Laura Cicirelli: They want to make sure you're incentivized to stay on board. Because if I leave now and my shares have not fully vested, I lose them.

Eric Weiner: Right. If you're fully vested and you walk away tomorrow, not great for anybody. So, oftentimes you will see funds ask, or at least present the fact that there might be some founder re-vesting. This is one of the reasons why we propose at formation that founders should have a standard four-year vest with a one-year cliff, because if you do have a standard vesting, investors are usually mindful of that and aren't going to try to re-vest you as hard as if you do not.

Laura Cicirelli: Yeah, no, that's right. And they want you to be incentivized the same way your co-founder did, to stay on board after my money is in and help run this company for some period of time. And so that's really important. And so that'll be negotiated. What percentage of my equity will be subject to this revisiting? What will the vesting schedule be?

It doesn't make sense for me to be subject to another cliff. I've been doing this for two years, three years. I've already proved myself. The cliff is not necessary. Let's just do monthly vesting. So that will be negotiated. So, there's some flexibility there, but don't be alarmed if you see the request. It is common, especially in the first stage of financing.

It's not common in a series A or B, because you know, you've at that point been in the game a long enough period of time.

Eric Weiner: The only thing I would say about this is sometimes you will see in the term sheet "founder vesting to be discussed." We would make sure that that is agreed to, what the reversing is going to be in the term sheet phase, before there's an exclusivity period between the investors and the founders.

Laura Cicirelli: Since we mentioned exclusivity period. Just quickly, what does that mean? So, once you sign a term sheet, there is going to be an exclusivity period there, usually, 30 to 45 days is what we normally see. Any longer than 45 days we would say is a bit off market, but what that means is for that period of time after the term sheet is signed, you cannot, as a company, go and shop this deal around and try to go get a better deal, right?

You're locked into the terms of this term sheet, and so you have to make a good faith effort to go and get those documents in place and close this deal in that period of time.

Eric Weiner: You're engaged and walking down the aisle with whomever the investor is that signed that term sheet, and you are not talking to anybody else until that period is over, or you've closed.

Laura Cicirelli: So, you as a founder, lose your leverage in the negotiation a bit once you're locked up in that way. So that's why we really want to make sure for things like vesting, those terms are in place at that stage before you go and lose your leverage.

Eric Weiner: Every term we've talked about should be very clear what they mean in the term sheet. And even though Laura and I did mention that you do see stuff like customary this and customer that. That is fine provided that, you know, there's little things on the edges. What we will write in term sheets around that, that make clear that there's not a lot of room to change the deal once you're in exclusivity, because yes, for companies, they are generally de-levered once they're in exclusivity because companies want the money, and investors have the money.

Laura Cicirelli: Yeah, absolutely. And another point with founder flexibility is the idea of "I hold this common stock. What can I do with it? Can I sell it?" And to Eric's point before, when we're talking about major investors with right of first refusal and co sale rights, the holders of common stock are going to be the founders included in that.

So, if you want to as a founder just go and sell to a third party, there's a process that you need to go through. You need to first offer it to the company and then to the major investors. And you know, most times I tell founders, don't be fearful of this. An investor is not going to block you in getting some liquidity if the company is doing really well and you have a third-party purchaser who's willing to offer you a good price for your shares. They want you to be rewarded in that way. You've put in a lot of work, and they're not going to block that for no reason.

Eric Weiner: If the company performs, you never see this used as a block ever.

Laura Cicirelli: Yeah. And by the way, it's not saying that they're getting some type of sweetheart deal, the major investors. If they want to purchase it, they have to purchase it on the same terms that you've negotiated with this third party. So, whether you get the money from an existing investor or this third party, it's not like they're getting any type of a discount.

Eric Weiner: Right. I mean, there could be… if the right of first refusal is now waived, I mean, there could be a perception from the potential third party buyer that he or she does not want to wait and go through that process to see if there's ways to negotiate against themselves.

But I think the point that Laura made, which I think is the most important one, is when company performs and founders want some liquidity in the markets we've seen over the last number of years, the founder gets the liquidity.

Laura Cicirelli: They want a happy founder. That's the goal. And then the last point I think for founder flexibility we want to talk about is just the idea of the drag along, and what does that mean. You'll see it in this documentation. What does it mean and how is it implemented? And so that is something that'll be negotiated at the term sheet stage.

What it is, is it means that if a certain requisite threshold of shareholders, and quite often the board as well, approved for a sale of the company in the future, then the other shareholders on the cap table can be dragged along into that sale. You don't need to get every single person to sign off on a sale. You can be what's called dragged along in the process.

Eric Weiner: And I think for founders, I mean, and this is a good provision generally, but for founders, look, usually the threshold that Laura was talking about is if holders of we agreed to a majority of the preferred threshold, approve a sale of the company and the holders of, let's say, a majority of the common, and usually will say who are continuing to provide services to the company as employees, officers or consultants approve a transaction, then the minority, the non-consenting stockholders, are dragged along into that transaction provided that they aren't treated adversely for the most part.

And the founders, you know, founders aren't always service providers of the company forever, so there is a chance that the founder is no longer in that holders of common stock then providing services to the company prong, and it could mean that down the road founder could be dragged.

Laura Cicirelli: Yeah, and it's important to just know at last point on the drag along, is you can only be dragged if you're a party to the agreement. So, it's so important over time for a company as you issue option grants and options are exercised and now these individuals are common holders, make sure they sign on to the document that has the drag along in it, because otherwise they're not subject to it, and you want to make sure that everyone, especially those small option holders, are now common stockholders are subject to the drag because they're the people who could collectively be an issue.

Eric Weiner: Yeah, I think it's pretty funny that we saved the drag for last, but I think the point you just made is so important. Everyone should sign up to the drag along it. It increases flexibility for the company and takes leverage away from really small stockholders. So, "oh we issued an option grant to an advisor who's going to hold .02% of the company."

Ok, well there's 15 of those people and they, you can't get them to sign or approve on to or sign on to the merger agreement or approve a sale of the company. That could add friction to the sale of the company. So, the drag is so important. Like I said, I think it's funny we waited till the end to talk about it, but I think at that point you made it's the critical one.

Laura Cicirelli: Yeah. No. Absolutely. And so, I think, you know that really it's hard to wrap up an entire equity financing in a single podcast. But really, I think the point of this is you're looking to raise money. It's a great thing. It's not something to be fearful of. Just be cognizant of the different controls you're giving away. And it's not that you should give no controls away.

There should absolutely be a balance of power here between you as the founder and the investor but just work with counsel to make sure you're comfortable and understand what you need on a go-forward basis, and that you don't run afoul of any of these contractual rights that you've agreed to.

Eric Weiner: Right? You've raised your safe financing, and that was easy and quick, and it really didn't have to negotiate a lot. Things change at the priced round. And there's a lot of considerations here. We've only had this podcast episode to talk about it, so the conversations are longer when you're actually doing it. But yeah, it's definitely nothing...

Eric Weiner: This is an amazing thing. You get a term sheet. You're going to raise money. This is the coolest thing ever. Its just things change for the business, and going forward, you have fundamentally changed the business going forward and how you're going to be able to behave going forward.

Laura Cicirelli: It's not bad change. Just change.

Eric Weiner: It’s just a change. Well look, the great thing is now we will be looking forward to our next episode where, now that you've raised money, and oftentimes a lot of companies raise money in order to help them hire, they've got money and they want to hire the talent that's going to help drive the business, so next time we're going to talk about hiring and Laura mentioned...

Laura Cicirelli: Compensating and yeah, all of that stuff, and we'll be joined with one of our colleagues. So that'll be an exciting one. So please join for that.

Eric Weiner: Thank you so much for joining us for “The Founders Hour.” If you enjoyed this episode, be sure to subscribe on Apple Podcasts, Spotify, YouTube, or wherever you listen so you don't miss future conversations.