Business Transactions Solutions § 156:390

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Part VI. Finance
Chapter 156. Venture Capital Financing
V. Additional Practice Tools
A. Training Materials

§ 156:390. Training Materials: Venture Capital Financing

§ 1. Overview

Venture capital is a unique source of funding. Venture capital covers a broad range of activities, and venture capitalists can be characterized in a number of different ways. However, venture capital can be distinguished from many other investment capital sources by the emphasis on selecting start-up and emerging companies and working with managers to build the business to the point where the venture capitalists can realize extraordinary returns on investment through a public offering or the sale of the company to a larger firm. Put another way, venture capitalists provide a commitment beyond mere money to the development of the firm.

§ 2. Investment decision factors

While it is difficult to draw sweeping generalizations regarding the key decision factors that a venture capitalist will consider in deciding whether or not to invest in a particular company, there are clearly some general rules of thumb that founders and managers must bear in mind during the negotiation process. Specifically, venture capitalists carefully review the experience of the members of the management team, both with regard to their general skills in building businesses and in the specific market where the company will be active. The projected return on investment is also very important particularly since venture capitalists need a few "big winners" to make up for those portfolio companies that fail to execute their business plans in highly risky and uncertain environments. In that regard, competitive and market conditions are obviously another major factor that must be considered. Finally, since venture capitalists do not want to hold their investments indefinitely they will only look at proposals that provide an opportunity for liquidity within three to five years.

§ 3. —Management team

Rapid changes and the global scope of most technology-based markets mean that company leaders must have substantial managerial skills. In fact, many venture capitalists claim that the most important aspect of any proposed investment is the quality of the management team. There are a number of management qualities that investors will generally seek, including honesty and integrity, experience and achievement, high levels of energy and commitment, and resilience to setbacks. While technical expertise and recognition among peers in the science community is obviously also important, a scientist turned entrepreneur must also demonstrate a commercial focus and experience working on commercial-based innovation projects.

Of particular interest to investors is the prior experience of the management team in the industry in which the company is involved and any track record the team has building a larger and more diversified business out of a company that has yet to develop a line of products. Experience in working with products that are produced and/or marketed globally is also important. If the management team is incomplete, the investors must be convinced that the founders and current managers are willing to seek candidates with the necessary background and experience. Other important attributes for managers include a willingness to communicate honestly with, and be coached by, the venture capitalist and acceptance of frequent evaluation against very clearly stated goals.

§ 4. —Return on investment

In order for an opportunity to be attractive, venture capitalists must have a reasonable expectation of a high return on the capital that they provide to the company. The required rate of return depends on a variety of factors, including the anticipated holding period, the level of financial and operational risk, the expectations of the venture capitalist's own investors, and the percentage of ownership of the company. As a general rule, venture capitalists seek a minimum annual investment return of 25%; however, in many situations, the target annual return can reach as high as 50% – 100%, particularly when the investors are providing seed capital or participating in the first round of outside financing. In each case, the investors will review the financial projections to estimate the anticipated value of the company in three to five years, as well as the expected dilution to their position resulting from future capital infusions. If the projections are subject to a good deal of risk and variation, or there are questions as to whether there will be any opportunities to liquidate the investment, then it is likely that the investor's return requirements will be increased.

§ 5. —Competitive and market conditions

Venture capitalists look for companies with a "unique" product or service that gives them a competitive edge, preferably because the company holds a proprietary position with respect to production and distribution of the product in every major global market. For some investors, it is important that the product or service be "evolutionary" rather than "revolutionary." This means that the product or service should be materially better than any existing solutions, but not so different that prospective customers cannot readily understand the benefits of the proposed product or service. In addition, venture capitalists focus on companies seeking to enter markets that are sufficiently large to generate substantial revenues, but which are not so big that they are likely to attract immediate competition from larger, more established companies. Each of these conditions, while valuable in their own right, also serves to provide time for the company to survive the early stages and develop the requisite functional capabilities to achieve high growth and stability. Given the importance of market size it is crucial that the business plan demonstrate the potential for expansion into global markets.

Venture capitalists will also be looking for companies that orient their proposed products and services toward actual and identifiable needs in the marketplace. Investors may be reluctant to invest in a company that produces products, while technologically superior, are not likely to achieve immediate market acceptance. In order to achieve the required market acceptance, the company's initial product or service must have a demonstrable competitive advantage in the eyes of customers. In addition, it is important for the company to be able to use its technological skills and expertise to produce a continuous stream of new products and services. Investors will want to be sure that the company is able to remain competitive, and protect its unique advantage over its competitors, after its first products have achieved a mature position in the marketplace. Put another way, the company must have a strategy for building a successful business, not just a string of technological gadgets that cannot attract a market following.

Market considerations relate to the venture capitalist's anticipated return on investment. If the company's products are too "revolutionary", it may take some period of time in order for the products to achieve market acceptance, thereby adversely affecting the investor's overall rate of return on investment. It is generally preferable for the company to be able to introduce, as soon as possible, one or more products that logically build upon current market offerings, thereby maximizing cash flow in the early stages of the company's development. This will ease the way for introduction of increasingly more sophisticated products that will capitalize upon any significant technological advantages that the company might have over preexisting market participants. In fact, a number of venture capitalists use early revenue generation as a key milestone to demonstrate that the technology has commercial viability.

§ 6. —Liquidity opportunities

While venture capitalists understand the need for patience and long-term involvement with portfolio companies, they will only invest in opportunities with clear exit strategies. Although venture capitalists typically prefer companies with business models that might be attractive for a public offering at some point in the future, there are other options. For example, an acquisition of the company by a third party, such as a large conglomerate or another firm in the company's industry, might be a real possibility. However, the need for a public offering or sale of the business may place venture capitalists at odds with managers and employees who prefer to continue operating the business independently. In order to avoid future problems, venture capitalists often seek and obtain the right to compel a sale of the company after a certain period of time if management has not taken the initiative to facilitate liquidity at an acceptable level of return.

§ 7. Evaluating prospective venture capitalists

Founders and managers need to proceed very carefully before making a final selection of a venture capital investor partner. It is important to remember that venture capitalists are, by their very nature, pro-active in their relationships with their portfolio companies and will constantly request, or demand, current information regarding the business. Moreover, venture capitalists generally have little patience for poor management practices or failure to meet agreed milestones. Given the many possibilities for friction with venture capital investors, the managers should consider each of the following issues before proceeding with the deal:

• Management should make inquiries in the industry to determine if the investor has the requisite skills, experience and business connections to provide assistance to the company. While this is true of the entire fund, it is particularly important with respect to the fund manager that will be directly involved with the company and its management team. Among other things, the company must be assured that the fund manager will have sufficient time to devote to the relationship.

• Management should contact the managers and founders of other companies that have accepted investment capital from the fund to get their views on how the relationship has evolved and what can be expected once the deal is closed.

• During the course of negotiations, attention should be paid to the manner in which the venture capitalist responded to the company's inquiries and the level of professionalism and cordiality that existed during the discussions. If there are personality issues before the deal closes, they will only get worse once the funds have actually been put at risk. Management must be comfortable with its ability to communicate openly and honestly with the fund manager.

• The venture capitalist should be able to assist the company in accessing necessary experience and knowledge in such diverse areas as technology, marketing, finance and human resources. Some investors have qualified personnel on their own staffs; in other cases, introductions to outside experts can be provided.

• The venture capitalist should have demonstrable access to investment bankers who, relying on the commitment made by the early investors, are willing and able to assist the company with private or public financings, joint ventures or acquisitions.

• The venture capital firm should be able to make a financial commitment that is consistent with the requirements of the company. In other words, the investment stage of the fund must match the company's present stage of development. If the fund is relatively mature, it may not have sufficient capital to make any required "follow on" investment in the company.

§ 8. Terms of investment securities

While, in theory, any type of security may be used in a venture capital financing transaction, the common choice for venture capitalists is convertible preferred shares that allow the holders to participate in any "upside" growth in the company while establishing a preference on liquidation if the venture is not successful. Use of preferred shares also permits creation of special class voting rights for the investors. There are certain instances where venture capitalists will accept other forms of investment instruments. For example, when a company is in financial distress it may issue convertible debt securities to raise short-term cash to fund operations until a larger equity round can be completed. A venture capital firm may also receive warrants and options covering common shares as an inducement to close the transaction.

§ 9. —Dividends

Preferred shares will be issued with the right to receive periodic dividends and will have a preference, or priority, over payment of dividends on common shares. A dividend preference may be either noncumulative or cumulative. Non-cumulative dividends are only payable if declared by the board of directors. Accordingly, even if funds are legally available to make a dividend payment, if the board decides not to make a distribution and retains the funds for use in the business, the dividend will be lost to the holders of the particular class of shares. In contrast, cumulative dividends that are not paid will continue to accrue over time and will be payable when funds are available or when declared by the board of directors. Sometimes dividends may be non-cumulative at the time of issuance but become cumulative after some date in the future, which date is usually set by reference to certain financial and operational milestones. The dividends on preferred shares will be set as a fixed amount per dividend period by reference to an agreed percentage of the purchase price of one share. Once these dividend preferences are satisfied, holders of the preferred shares may also be entitled to participate in dividends paid to holders of common shares on an "as-if-converted" basis, which means that the holders of the preferred shares will receive the same amount of common stock dividends as they would have received if they had converted their preferred shares into common shares. As a practical matter, the dividend preferences do not often come into play since it is rare for emerging companies to pay dividends to their shareholders before they complete a public offering, an event which triggers automatic conversion of the preferred shares into common shares and eliminates the dividend preference.

§ 10. —Winding up

Holders of preferred shares are generally given a priority claim over the holders of the common shares to receive a fixed amount upon winding up of the company before any distribution is made with respect to the common shares. The preferential amount payable on winding up typically equals the original purchase price of the subject securities plus any and all accrued but unpaid dividends. In many cases, mergers and similar "sale events" will be deemed to be a "liquidation," thereby insuring that the investors will at least have the right to receive the amount of their original investment back upon the occurrence of such a transaction. In many cases, holders of preferred shares will be better off upon winding up by converting their shares into common shares and sharing in distributions made to all holders of common shares. If, however, the preferred shares are "participating," holders thereof will be entitled to receive not only their preference on winding up but also the amount they would have received had they elected to convert the shares into common shares. A participating feature can substantially dilute the economic interest of managers and employees holding common shares. As a compromise, participation of the preferred shares can be subordinated to payment of a fixed amount to holders of common shares or can be limited to a specified level of return.

§ 11. —Voting rights

Venture capitalists are able to exercise significant control over the company through special class voting rights provided to them as the holders of the preferred shares. While the voting rights of the preferred shares are generally pari passu with the voting rights of the common shares, holders of the preferred shares will be given the right to vote as a separate class on certain transactions. For example, the consent of a specified percentage-in-interest of the outstanding preferred shares will be needed for the issuance of new senior securities, mergers and acquisitions, a material change to the company's business plan, winding up of the company, and amendments to the company's organizational documents (i.e., articles of incorporation and bylaws). Also, holders of preferred shares will usually be given a separate class vote with respect to the election of directors, as explained below.

§ 12. —Conversion

The preferred shares issued to the venture capitalists will be convertible into common shares at the discretion of the holder. In addition, automatic conversion of the preferred shares will usually be required upon the occurrence of certain "exit events," as defined in the rights and preferences associated with those shares. For example, automatic conversion may be mandated upon completion of an agreement for the sale of the company or the initial public offering of the company's common shares. Some investors will impose conditions on the automatic conversion of the shares at the time of an initial public offering. Typical conditions might include a requirement that the offering must be "firmly underwritten" and that the "per share" and the aggregate offering price of all shares sold in the offering equal or exceed stipulated levels. The per share price will generally depend on the timing of the investment and may be anywhere from three to five times the common share equivalent price paid by the investor. The aggregate offering price condition is intended to insure that the public market for the common shares will be sufficiently large to provide liquidity for the investors' shares.

Automatic conversion may also occur upon the company's attainment of certain performance goals and objectives, including the closing of a private placement financing in excess of a certain minimum dollar amount or the achievement of specified revenue or net sales standards. In addition, conversion may be triggered by the vote of a certain percentage-in-interest of the holders of the preferred shares (e.g. 66-2/3%), thereby permitting a capital restructuring of the company without needing the consent of all the investors. In addition, allowing a majority, but less than all, of the holders of the preferred shares to trigger conversion of all of the preferred shares prevents a small group of investors from continuing to use any special class voting rights to disrupt the affairs of the company.

Typically, the conversion ratio for the preferred shares is initially established at one common share for each preferred share, subject to equitable adjustment for any future adjustments to the company's capital structure (e.g. stock splits or dividends). Venture capitalists will also insist on "anti-dilution" protection that requires an adjustment of the conversion ratio (and a corresponding increase in the number of common shares issuable upon conversion) if the company subsequently issues common shares (or equivalents) for less than the price paid by the investors. The most common anti-dilution provision uses a "weighted average" formula that calculates the adjustment based on the number of shares outstanding before and after the new issuance and the price per share paid for the new securities. A more drastic alternative adjusts the ratio as if the earlier investors paid the same lower price as the new investors. In either case, the ownership interest of the management team will be significantly diluted. Exceptions to the anti-dilution provisions are usually carved out for issuances of shares to employees for incentive purposes that have been approved by the investors.

§ 13. —Redemption

Venture capitalists generally do not require mandatory redemption provisions for their convertible preferred shares. However, in a limited number of cases, the company may be given a right to repurchase or redeem the preferred stock at its purchase price plus a redemption premium. These "optional" redemption provisions provide the company with a method for forcing investors to convert their holdings into common shares if the investors want to retain its interest in the growth of the company. By forcing conversion, the company can eliminate the special rights associated with securities normally issued to investors with respect to dividends, liquidation and voting. Realizing the leverage that optional redemption rights can provide the company, investors are generally reluctant to agree to such provisions. On the other hand, the company may obtain agreement on this issue if it agrees to defer exercise of the option for a specified period of years. There are situations where the investors will be given the right to force the company to redeem the shares at the option of the investors. This right, which, in effect, is a "put," is little different from mandatory redemption provisions when investors can waive or defer redemption. In most cases, the put rights will only become exercisable upon the occurrence of stipulated events, such as a material default by the company with respect to ongoing financial and operational covenants.

§ 14. Valuation and pricing

Valuation, particularly for a start-up company with little or no track record, is both a science and an art, and should be approached with a respect for market factors and the realization that many venture capitalists rely on a certain amount of intuition regarding the prospects of a company. Obviously, there are a wide variety of theoretical methods that can be used to value a company, such as paying some multiple of earnings over the next five years. All of these may be considered in pricing a deal, but some of the most valuable information comes from discussions with persons active in the marketplace, including investment bankers, consultants and accountants. In setting the asking price, founders and managers must always consider that there may be a need for further equity financing down the road in order to achieve the ultimate financial objectives. If this is so, they must be sure that they do not give up so much of their equity interest in the company for the first infusion of financing that they lose the incentive to continue with the venture.

Ultimately, the agreed valuation, and resultant pricing of the securities, in a venture capital transaction will come down to difficult negotiations between management and the investors. At best, the following list of factors can be used as a starting point in the valuation process:

• The total amount of financing, and resultant future dilution, required to bring the company to a position where the investors can achieve liquidity for the investment at a level that satisfies the investor's risk-adjusted rate of return requirements;

• The pricing of comparable investments, which requires an analysis of actual and potential competitors, both private and public, as well as the price paid by early-round investors;

• The attractiveness of competing investment opportunities at the time that the financing is being considered, as well as the need for the investor to retain capital for use in providing further funding to existing portfolio companies;

• The risks associated with the company, which can be determined by analyzing the business history of the company, the industry within which it operates, competitors, and the skills and experience of the management team;

• The historical and projected earnings and profits of the company, as well as the need to retain income for future investment and the ability to make dividend payments; and

• The book value, assets and overall financing condition of the company, although book value is rarely a good method for valuing businesses engaged in development of new products and having little manufacturing capability or inventories.

§ 15. Company agreements and covenants

Venture capitalists typically require that their portfolio companies enter into a series of agreements and covenants regarding management of the company's affairs. As a general rule, the agreements remain in effect for as long as a specified amount of the securities remain outstanding; however, the covenants, with the exception of requirements for delivery of the financial information, will almost always terminate on the completion of the company's initial public offering.

The covenants in these agreements generally fall into two broad categories: "affirmative" covenants, which impose duties and obligations on the future activities of issuer, and "negative" covenants, which prohibit the issuer from taking certain future actions. For example, one common affirmative covenant is the obligation of the company to provide the investors with certain financial information about the company. Standard negative covenants prohibit the company from entering into various specified transactions, such as a merger or an acquisition, or from amending the charter documents, without obtaining the consent of a specified percentage-in-interest of the investors.

The scope and nature of the required covenants will vary with each investor and the nature of the investment instrument. For example, if the investors will control the company's board of directors following the closing of the transaction, the covenants, if any, will generally not be very burdensome, since the investors will rely on their control of the board to manage the company's continued operations. On the other hand, if the investors will not control the board following closing, and the investment is in the form of an equity investment, the required covenants will necessarily be more extensive. Similarly, if the investment takes the form of a debt instrument, the covenants will usually be more extensive since the holders of debt securities are less likely to participate directly in management of the company.

The rights discussed in these sections may be included in the company's organizational documents (i.e., articles of incorporation and/or bylaws), in the investment or subscription agreement, or in a separate form of investors' rights agreement. Founders and other members of the management team will also normally be parties to the covenants and obligations.

§ 16. —Information rights

The company will almost always agree to provide the investors with financial and operating information, including annual and quarterly balance sheets and income statements prepared in accordance with generally accepted accounting principles applied on a consistent basis. In addition, major investors (i.e. those that have invested significant amounts) may be given supplemental rights to receive monthly reports of sales, production, shipments, profits, cash balances, receivables, payables and backlog; budgets and projections; all information filed with regulatory agencies; and notification of significant lawsuits or other legal proceedings. Other notices and information that might be included in information rights might include information on material casualties with respect to company property, notices of defaults under any material contract of the company, and copies of any new material contracts entered into after the date of the investment agreement. In some cases, the financial information must be accompanied by a certificate from the company's chief executive or financial officer and, in the case of audited financial statements, its auditors, to the effect that the company has complied with the investment agreement.

§ 17. —Management participation

One of the principal differences between a venture capital investment and other investments is the desire of the investors to actively participate in the management of the company through representation on the company's board of directors. The degree of participation will vary depending upon the circumstances. For example, in many cases, the investors are context to elect one member, or a greater number that is still a minority of the members of the board. In other cases, the investors may insist on the right to name a majority of the directors. Another common scheme provides that both the investors and the management team will have equal representation on the board, perhaps with an option to allow the designated directors to elect additional independent board members.

There are a number of pros and cons to be considered by management with respect to the degree of control that will be given to the investor group. Certainly, investor participation on the board provides a good method for insuring that investors are kept apprised of company activities and for building a strong consensus on appropriate business strategies. Also, the investor members may provide assistance in recruiting independent members of the board who can bring additional expertise or business relationships to the company. On the other hand, management may believe that investor control of the board will impair their ability to make key strategic decisions.

If the investors do not control the board of directors from the outset, they may insist on the right to elect a majority of the board if the company defaults on material agreements and covenants in the investment agreement. Material events of default may include a violation of the various affirmative and negative covenants described below or failure to meet certain agreed-upon business or financial goals. In most cases, the right of investors to elect a majority of the board continues for so long as the default has not been cured.

§ 18. —Rights to acquire additional shares

Investors are generally provided in the investors' rights agreement with various rights and options to acquire additional shares. For example, it is common for investors to be granted a subscription option to purchase further shares of the type that is being issued in the financing up to a stated maximum and at the same price as he subscribed for his original shares. These types of options are often used to allow managers of the venture capital funds to participate in their portfolio investments on favorable terms.

In addition, investors may be given the right to participate in future company financings, thereby allowing the investor to maintain or increase its ownership interest in the company. Participation rights make take a variety of forms, such as a right of first refusal to purchase all securities offered by the company for financing purposes in the future, with each investor allocated the right to purchase a pro-rata share; preemptive rights, which allow investors to maintain their pro-rata ownership percentage after the financing has been completed; or simply the right to discuss financing opportunities with the company before it begins negotiations with third parties without any other binding obligation on the company.

Participation rights may be limited to "major investors," defined as investors who own at least a certain specified amount of the company's securities. Certain offerings may be excluded from the participation rights, including conversions of outstanding securities or exercise of outstanding options or warrants, securities issued in connection with acquisitions or other types of strategic transactions, and securities issued pursuant to the terms of any employee benefit or compensation plan. In addition, participation rights may be limited to equity securities, thereby preserving the company's ability to issue debt securities when appropriate. The participation rights generally expire upon completion of the company's initial public offering; however, an investor's right may terminate earlier if it fails to exercise a right as to one or more subsequent financings.

§ 19. —Affirmative and negative covenants

The obligations of the company with respect to delivery of information, management participation, subsequent financings, and other matters are the most common, and important, covenants required in a venture capital financing. In some cases, however, investors may require a wide range of other covenants relating to various aspects of the company's day-to-day operations and activities. These covenants are similar to those in commercial loan agreements, since banks and other lenders typically require extensive covenants to compensate for the fact that lender representatives do not serve as directors of the borrower.

As noted, covenants are categorized as "affirmative" or "negative." Affirmative covenants are phrased in terms of actions that management will be obligated to take with respect to the company's business and its properties and contractual relationships. For example, common affirmative covenants address the use of proceeds from the offering, compliance with applicable laws and regulations, maintenance of properties and assets, and perfection and protection of intellectual property rights. In contrast, as the name implies, negative covenants generally limit or restrict management's ability to take certain actions without obtaining the consent of the investors and, as such, often become the subject of long and extensive negotiations. In almost every case, the investors will insist upon a vote with respect to matters that will fundamentally impact their investment in the company, such as acquisitions, mergers and issuance of new securities that would dilute their interest in, and control over, the company. Additional items that may become the subject of negative covenants include prohibitions on creating indebtedness, related party transactions, or allowing certain financial ratio to deteriorate below specified levels.

§ 20. —Employee stock ownership

Another area of great debate in any venture capital investment transaction is the percentage of equity ownership of the company that will be set aside for attracting and motivating key employees once the financing has been completed. The ability to use equity incentives, in the form of stock options, has long been seen as an important factor in recruiting executives to fill out holes in the management team, as well as talented engineers, scientists and sales personnel to develop and sell the company's products.

Negotiations in this area focus on the size of an "employee stock pool" for future issuances, which will typically vary within a range of 5% to 20% of the fully diluted equity of the company. Issuances of that number of shares will be exempted from any negative covenants, anti-dilution provisions, or rights of first refusal relating to future share issuances. However, while the investors may have agreed on the number of shares that can be issued, they generally will closely scrutinize how the shares are allocated in the course of their service on the board of directors.

Shares issued to employees will be subject to "vesting" restrictions that require that an employee must remain in the employment of the company for a specified period of time before the employee becomes entitled to the full economic benefits of owning the shares. If the employee leaves the company prior to the date specified in the agreement, the company would have the option to repurchase that portion of the employee's shares that have not vested prior to the date of departure. The repurchase price for these unvested shares is generally equal to the price originally paid by the employee for the shares, although in some cases the employee will also receive an additional amount in the form of interest on the original price from the date of purchase.

§ 21. —Management agreements

Each of the ancillary agreements discussed above are an important element of any venture capital financing transaction. In addition to voting agreements that establish the procedures for implementing the agreement of the parties with respect to management participation, each founder and senior manager will be required to sign share transfer restriction agreements, including right of first refusal and co-sale provisions. Also, it is typical for venture capitalists to require formal employment agreements for each executive director that sets out the duties and compensation for each person, as well as restrictions on other activities of the executive during and after the term of employment. In addition, each of the key managers and technical employees of the company will be required to execute assignments covering any legal rights they might have in intellectual property to be used in connection with the company's business plan.

Apart from the aforementioned agreements, venture capitalists will also want to discuss the ownership stake of the management team. Since the venture capitalist's decision to invest in a company is heavily influenced by the management of the company, the investor will want assurances that the management team will remain with the company for a certain period of time after the investment is made. This is generally accomplished by imposing some form of vesting restrictions and associated repurchase rights on shares already owned by the managers to force them to "earn" their equity by continuing to work for the company. If the company has recently been formed, all or most of the shares of the management team will be placed on vesting schedule similar to the one used in connection with issuances under the employee stock pool described above. If, however, the company has been in operation for some period of time and the managers have already made a significant level of contributions to the company, many investors will agree to exclude a portion of their shares from the vesting provisions. For example, if a director has been active with the company for two or three years, vesting may only be imposed on 50 percent of the director's shares and the vesting period for those shares would be limited to just two years, rather than the typical four years.

§ 22. —Realization of investment

Given that the ultimate objective of a venture capitalist, or any outside investor, is to realize a return on the original investment, hopefully at a substantial profit, it is common for the investment documentation to include provisions relating to the investor's exit from the company. There is a wide range of possibilities that might be considered, such as the following:

- A simple "best efforts" obligation imposed on the founders to effect a realization of the investment within a specified period of time, without detail as to form of exit.

- An option in favor of the investors to put their shares back to the company, subject to the requirements and restrictions in the applicable state corporations law statute (i.e., the statute of the state in which the company is incorporated), if realization has not been achieved within a specified period of time. In some cases, the founders will be obligated to purchase the shares if the company is not able to perform.

- A right for the investors to sell their shares to a third party free of any restrictions on transferability of the shares, such as a requirement that the shares must first be offered to the company and/or other shareholders.

- A right for the investors to seek a purchaser for all the outstanding shares of the company coupled with a binding obligation on the founders to sell their shares on the same terms and conditions negotiated by the investors.

- A right for investors to have all or a portion of the investor's shares included in a secondary offering of shares to the public, perhaps at the time the company makes its own initial public of new securities for capital-raising purposes. These "registration rights" are commonly requested by venture capitalists; however, their value to investors depends on the assessment of the company's investment bankers as to how the market will react to a secondary offering.

§ 23. —Fees and expenses

Venture capitalists will normally require that the company reimburse the investors for professional fees incurred by the investors during the due diligence and negotiation stages. Some companies may be successful in setting ceilings on the amount of required reimbursement for professional fees. In addition, the company will be required to cover the travel and administrative expenses incurred by venture capital representatives in carry out their duties and responsibilities as members of the board of directors of the company following the closing.

Footnotes

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