2017 Venture Capital Report

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2017 Venture Capital Report – Table of Contents

REVIEW

Following record levels of financing activity and proceeds in 2014 and 2015, the venture capital market cooled in 2016, with a decrease in the number of financings and a sharp contraction in valuations. Despite the decline in deal flow, however, the $52.4 billion invested in the US venture capital ecosystem still represented the third-highest annual total since 2000. Once all 2016 deals are accounted for, the number of 2016 venture capital financings should be commensurate with the 4,039 deals in 2013. VC-backed company liquidity activity was mixed in 2016, with the M&A market producing strong levels of acquisition activity and attractive valuations, while the IPO market declined for the second consecutive year to its lowest annual level since 2009.

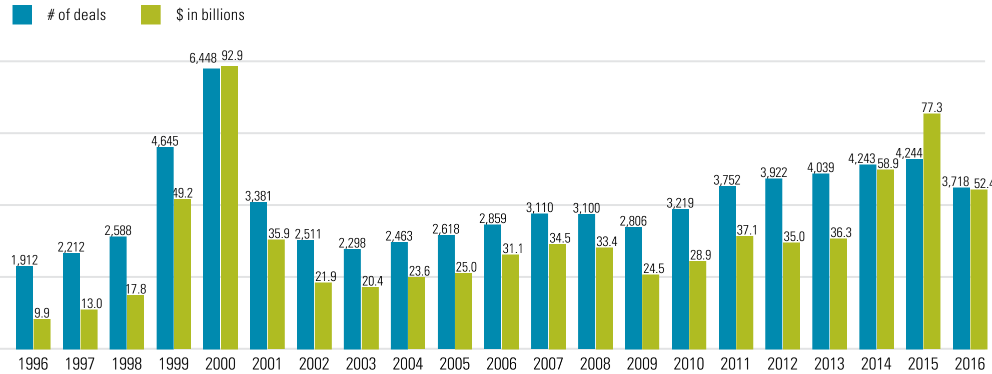
Equity Financing Activity

The number of reported venture capital financings declined by 12%, from 4,244 in 2015 to 3,718 in 2016. Even adjusting for the normal lag in deal reporting, deal flow appears to have slowed toward the end of the year, with the 862 deals in the fourth quarter representing the lowest quarterly tally since the first quarter of 2011.

Total reported venture capital financing proceeds contracted by almost one-third, from $77.3 billion in 2015 to $52.4 billion in 2016. Despite falling short of the total annual proceeds in 2014 and 2015, the 2016 figure is 52% higher than the annual average of $34.5 billion that prevailed for the three-year period preceding 2014.

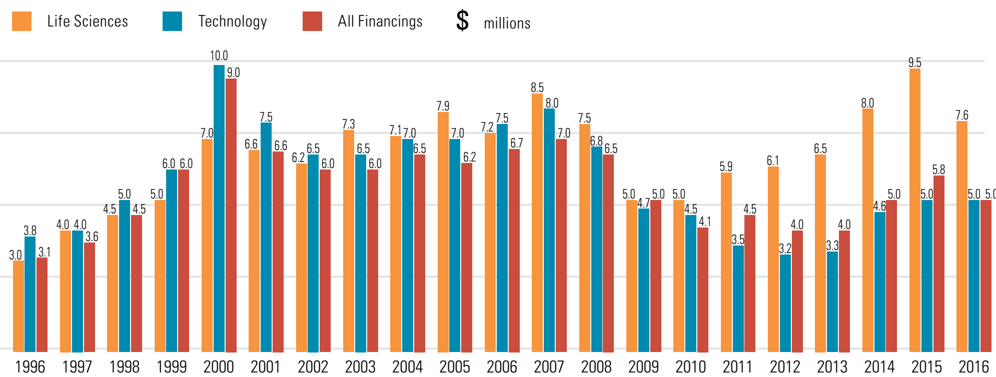
The median size of all venture capital financings decreased 12%, from $5.8 million in 2015 to $5.0 million in 2016—but still tied with 2009 and 2014 as the second-highest level since 2008. The median size of first-round financings decreased 8%, from $3.25 million in 2015 to $3.0 million in 2016. The median size of second-round financings decreased by a wider margin, down 15%, from $7.3 million in 2015 to $6.2 million in 2016. Later-stage financings experienced the largest decline, their median size contracting by 28%, from $15.0 million in 2015 to $10.9 million in 2016. While the 2016 figure is also well shy of the

US Venture Capital Financings – 1996 to 2016



Source: Dow Jones VentureSource

Median Size of US Venture Capital Financings – 1996 to 2016



Source: Dow Jones VentureSource

$14.0 million figure for 2014, it is comparable to the $10.0 million annual median that prevailed between 2011 and 2013. In this light, 2016 should be regarded as a return to normalcy following a two-year period with elevated valuations.

After increasing for five consecutive years, the median financing size for life sciences companies declined from $9.5 million in 2015 to $7.6 million in 2016. For technology companies, the median financing size remained steady at $5.0 million, still significantly lower than the typical annual median during the ten-year period preceding 2009. The general decline in the median financing size for technology companies in recent years is at least partly attributable to technological advances that have enabled startups to commence and grow their operations with a lower level of funding than historically required—in many cases, cloud computing and open-source software have replaced the need to purchase expensive server racks, hire support staff and acquire costly software licenses.

Between 2012 and 2015, the volume of very large financings increased dramatically, as venture-backed companies increasingly relied on IPO-sized later-stage rounds of financing—sometimes with the intention of eschewing the public markets entirely. The number of financing rounds of at least $50 million increased from 83 in 2012 to 112 in 2013, almost doubled to 209 in 2014, and then increased a further 35% to 283 in 2015. The number of financing rounds of at least $100 million increased from 19 in 2012 to 28 in 2013, more than doubled to 63 in 2014, and then leapt another 63% to 103 in 2015.

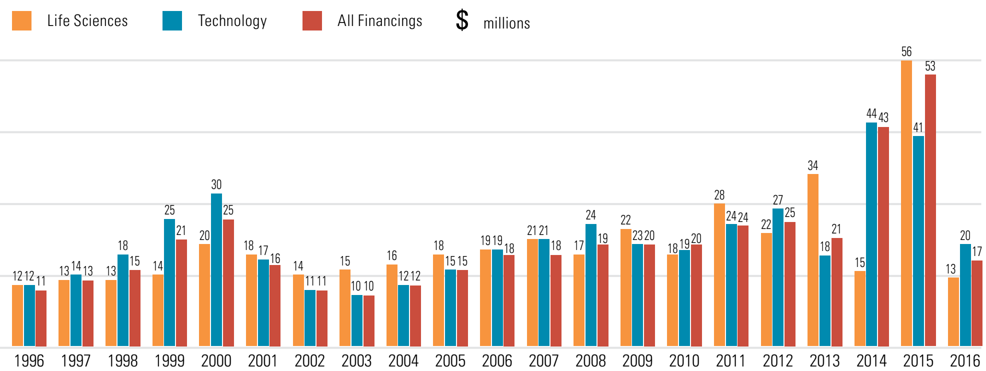
Through 2015, the increases in super-sized rounds were driven largely by private equity, crossover and hedge funds, which historically had avoided investments in private companies, but were attracted to pre-IPO companies that offered the potential for sizeable valuation increases and investment returns, especially when investors were able to negotiate ratchet provisions guaranteeing them a minimum return at the time of an IPO, typically in the form of additional shares if the offering priced below a set price. As these investors became wary of sky-high valuations, the number of financing rounds of at least $50 million declined by 37%, from 283 in 2015 to 177 in 2016, and the number of financing rounds of at least $100 million decreased by 58%, from 103 to 43.

There were a pair of billion-dollar financing rounds in 2016, down from six in 2015. This elite club was led—for the third year in a row—by Uber, with a $3.5 billion financing on top of its $2.1 billion and $1.0 billion financings in 2015. The other billion-dollar financing in 2016 came from Snap, with a $1.16 billion-dollar financing at a valuation of $17.8 billion that now looks to have been a solid investment, as the company went public in March with a $24 billion valuation.

The median pre-money valuation among all venture financings in 2016 fell to its lowest level in ten years, declining by more than two-thirds, from $53.4 million in 2015 to $16.8 million in 2016. Both life sciences and technology companies experienced sharp decreases in valuations. The median pre-money valuation in the technology sector decreased 52%, from $41.3 million in 2015 to $20.0 million in 2016. Life sciences companies saw an even greater drop, with a median pre-money valuation that plunged by 76%, from a record high of $56.2 million in 2015 to $13.4 million.

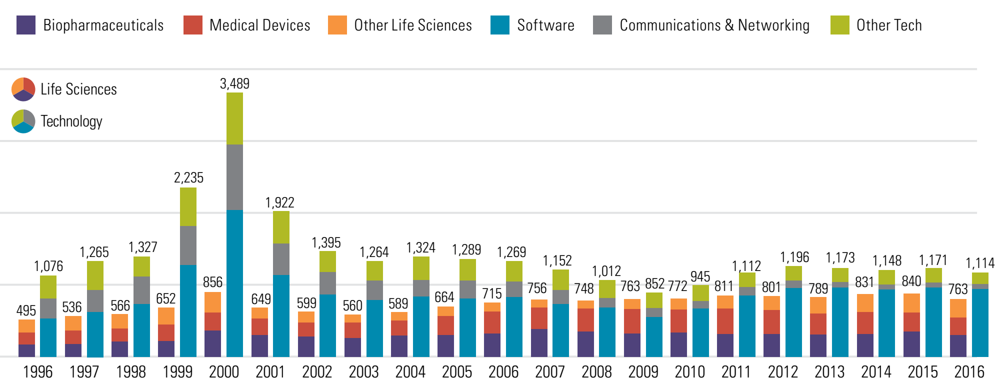
While the 2016 figures are likely understated, the number of reported seed and first-round venture capital equity financings declined by 36% and 13%, respectively, between 2015 and 2016.

Median Pre-Money Valuation in US Venture Capital Financings – 1996 to 2016



Source: Dow Jones VentureSource

US Venture Capital Financings by Industry – 1996 to 2016



Source: Dow Jones VentureSource

Seed and first-round financings accounted for 40% of all venture financings in 2016—down from 42% in 2015 and 45% in 2014. Proceeds from seed and first-round equity financings represented 17% of all venture capital financing proceeds in 2016, up from 13% in 2015 and 16% in 2014. The number of second-round and later-stage financings decreased by 12% and 10%, respectively, between 2015 and 2016. Proceeds from later-stage equity financings represented 53% of all venture capital financing proceeds in 2016, down from 63% in 2015.

The technology sector accounted for 30% of the year's transactions in 2016, up slightly from 28% in 2015. The business and financial services sector (which had supplanted the technology sector for the largest market share for the first time in 2014) saw its market share decline from 25% to 24%. The market share for life sciences companies increased for the third year in a row, from 20% in 2015 to 21% in 2016.

California—which has led the country in financing activity in each year since 1996—accounted for 41% of all venture financing transactions in 2016 (1,529 financings) and 52 % of all proceeds ($27.3 billion). New York, home to companies with 442 financings raising $5.67 billion in 2016, finished second in deal flow for the fifth year in a row, just ahead of Massachusetts, which logged 281 financings raising $5.00 billion. Texas (with 142 financings raising $1.36 billion) and Washington (with 124 financings raising $1.26 billion) rounded out the top five positions for 2016.

Liquidity Activity

The number of venture-backed US issuer IPOs, which dropped from 102 in 2014 to 63 in 2015, declined for the second consecutive year, numbering only 39 in 2016—the lowest annual level since 2009. The largest VC-backed IPO of 2016 was the $237.9 million offering of Nutanix, followed by the IPOs of Cotiviti Holdings ($237.5 million), Twilio ($150.0 million) and Coupa Software ($133.2 million). The median amount of time from initial funding to an IPO increased from 6.3 years in 2015 to 7.7 years in 2016—the highest annual level since the 8.1-year median recorded in 2010.

In 2016, 60% of all VC-backed IPOs were by life sciences companies, down from 68% in 2015 and 62% in 2014, while the VC-backed IPO market share for technology companies increased to 36% in 2016 from 30% in 2015 and 34% in 2014—still well below the 60% market share that prevailed in the five-year period preceding 2014.

The median amount raised prior to an IPO increased for the second consecutive year, jumping 6%, from $92.1 million in 2015 to $97.9 million in 2016, while the median pre-IPO valuation decreased 3%, from $242.2 million to $234.7 million. As a result, the ratio of pre-IPO valuations to the median amount raised prior to an IPO by venture-backed companies going public decreased to 2.4:1, its lowest level in the last 20 years, down from 2.6:1 in 2015 (a lower ratio means poorer returns to pre-IPO investors). The ratio was between 3.2:1 and 5.5:1 for each year from 2001 to 2012, other than a spike to 9.0:1 in 2009 based on a very small sample size of VC-backed IPOs that year. In contrast, this ratio ranged from 7.5:1 to 10.0:1 from 1997 to 2000, due to very large pre-IPO valuations by younger companies.

The number of reported acquisitions of VC-backed companies increased 6%, from 531 in 2015 to 561 in 2016, while total proceeds increased 42%, from $58.1 billion to $82.4 billion. This tally represents the third-highest annual level in 16 years, lagging behind only the $97.8 billion figure in 2000 at the height of the dot-com boom and the $88.5 billion figure in 2014. Once all 2016 acquisitions are accounted for, 2016 deal flow should further increase its margin over the 2015 result.

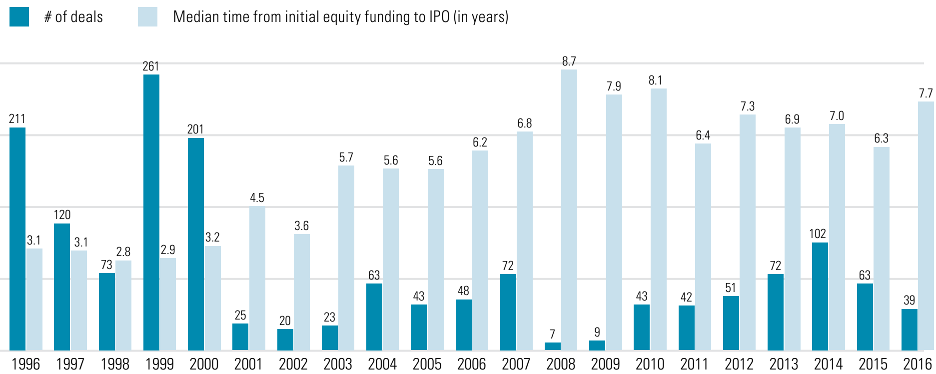
The median acquisition price for venture-backed companies increased 39%, from $70.0 million in 2015 to $97.5 million in 2016—the highest annual figure since the $100.0 million in 2000. The median amount of time from initial funding to acquisition increased to 4.9 years in 2016 from 4.6 years in 2015, but nonetheless represents the second-lowest annual figure since 2005.

The median amount raised prior to acquisition increased 4%, from $12.0 million in 2015 to $12.5 million in 2016. The ratio of median acquisition price to median amount raised prior to acquisition increased from 5.8:1 in 2015 to 7.8:1 in 2016 (a higher ratio means higher returns to pre-acquisition investors). This ratio in 2016 was the highest annual figure since the ratio of 10.0:1 in 2000 at the apex of the dot-com delirium. The increase in this ratio largely stems from significantly higher acquisition prices, coupled with historically low investment levels prior to acquisition.

There were a total of 16 VC-backed company acquisitions that fetched at least $500 million in 2016, down from 19 in 2015 and 23 in 2014 but well above the nine in 2013. The eight billion-dollar acquisitions of VC-backed companies in 2016 equaled the prior year's tally, but fell one short of the 2014 total. The year's largest VC-backed company deal was AbbVie's acquisition of Stemcentrx for $5.8 billion.

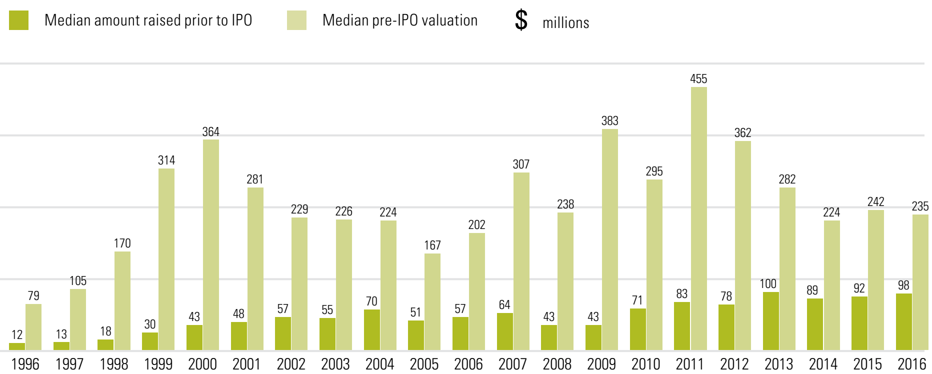
The above comparison of the ratios of valuations to the financing amounts required to achieve liquidity events indicates that—for the fourth time since

Venture Capital–Backed IPOs and Median Time to IPO – 1996 to 2016



Source: Dow Jones VentureSource and SEC filings
The above chart is based on US IPOs by VC-backed US issuers.

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1996 to 2016



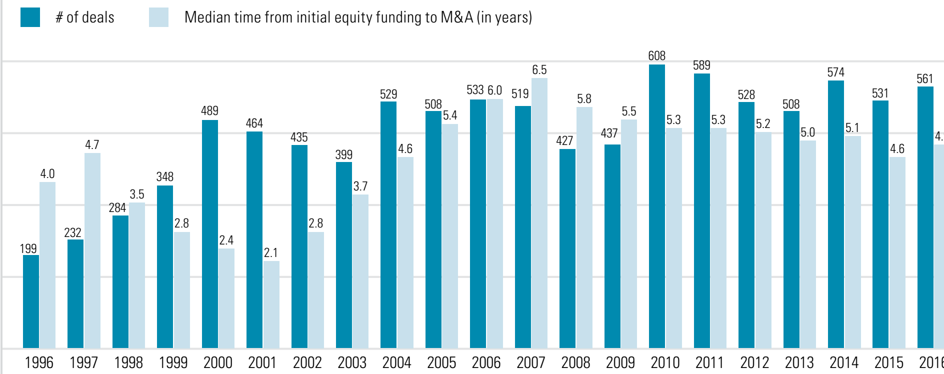
Source: Dow Jones VentureSource

2000, and for the fourth consecutive year—returns to venture capital investors in 2016 were higher in M&A transactions than in IPOs. Furthermore, venture investors generally achieve liquidity more rapidly in an M&A transaction (which frequently yields the bulk of the purchase price in cash at closing) than in an IPO (which generally involves a post-IPO lockup period of 180 days and market uncertainty on the timing and prices of subsequent sales).

When combined with 2016's shorter timeline from initial funding to liquidity for M&A transactions (4.9 years) than IPOs (7.7 years), these data points underscore why venture capitalists often prefer a company sale to an IPO. The average 2016 VC-backed IPO did, however, gain 30% during the year, with 66% of IPO companies trading above their offering price at year-end.

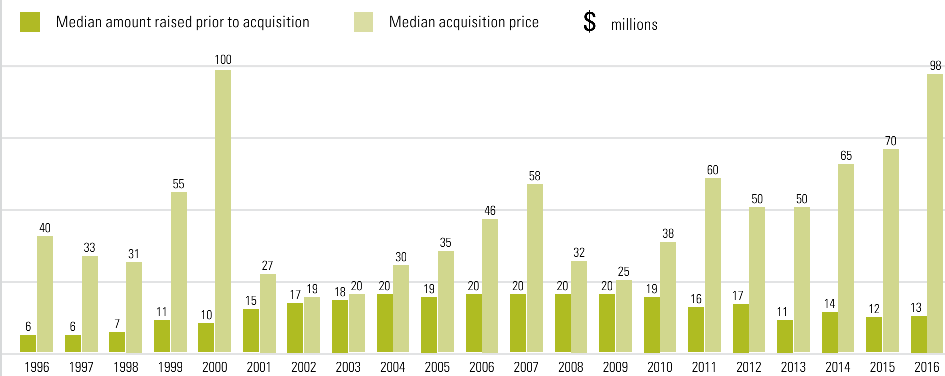
Following on the heels of 2015's increase in the ratio of M&A transactions to IPOs—which rose to 8.4:1 from 5.5:1 in 2014, reversing six years of consecutive declines—the ratio increased again, reaching 14.4:1 in 2016.

Acquisitions of US Venture-Backed Companies and Median Time to M&A – 1996 to 2016



Source: Dow Jones VentureSource

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1996 to 2016



Source: Dow Jones VentureSource

OUTLOOK

Financing and liquidity activity in the venture capital market over the coming year will depend on a number of factors. After declining in 2016, the market continues to face the headwinds of a tepid IPO market, a slowdown in M&A activity and a pullback by crossover investors. At the same time, the large amount of capital raised by venture capital funds last year, combined with a resurgence in corporate venture investing, should mean that good companies—especially those with founders who have successful track records—continue to get funded.

- *Financing Activity*: Venture capital fundraising in 2016 was at its highest level in a decade, while investment activity declined. With sharp decreases in valuations, deal flow can be expected to pick up as prior concerns over excessive valuations dissipate. The anticipated uptick in financing activity is not yet evident in the first quarter of 2017, however, as macro factors continue to weigh on the market.
- *IPOs*: At the start of 2017, there are more than 150 "unicorns" (startup companies whose valuations exceed $1 billion), along with other companies that are qualified to pursue an IPO. Many of these companies have opted for the relative ease of private fundraising and chosen to remain private. Others are likely waiting for more favorable market conditions. The solid aftermarket performance of VC-backed IPO companies in 2016—on average, they gained 30% from their offering price through year-end—is likely to generate demand for additional VC-backed IPOs in 2017. Snap's very successful IPO in March 2017 may provide a further spark to the market.
- *Acquisitions*: Public companies' balance sheets remain strong, and favorable interest rates can help strategic acquirers supplement organic growth through acquisitions. Nonetheless, the level of M&A activity in the coming year will depend in part on trends in private company valuations.
- *Attractive Sectors*: Companies offering products that leverage AI and machine learning, especially in the enterprise environment, should continue to attract funding in 2017. Other industries that should receive significant investment include agriculture and food, enterprise SAAS solutions, fintech, healthcare-related IT, robotics and security. Life sciences companies with compelling market opportunities—such as those in immuno-oncology and gene therapy—should also continue to appeal to investors. Investor focus on companies developing consumer-facing applications, especially in the digital media space, is likely to continue to decline. ■

CALIFORNIA

California companies reported 1,529 financings in 2016, down 15% from the 1,794 financings in 2015, although the 2016 count is likely understated due to delayed reporting. Total proceeds declined by 39%, from $43.2 billion to $27.3 billion.

The decrease in proceeds from California financings was largely attributable to a decline in the number of very large rounds, mirroring nationwide trends. The number of rounds in the state raising $50 million or more fell 36%, from 159 in 2015 to 102 in 2016, while the number of rounds of $100 million or more plunged 64%, from 70 to 25.

Overall, California was responsible for 41% of all financing transactions in the country in 2016, down slightly from 42% in 2015, but the state still produced 58% of the nation's financing rounds of $50 million or more.

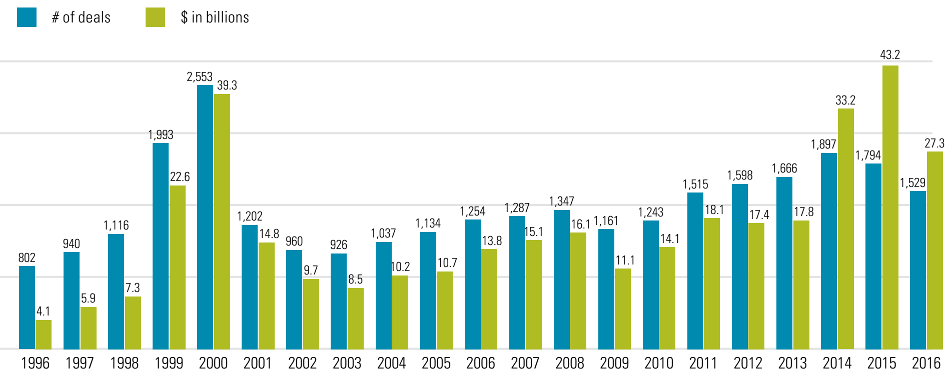
Technology was the largest sector in the state, with 36% of all California financings in 2016, followed by business and financial services (25%), consumer goods and services (18%), and life sciences (also 18%).

The number of IPOs by California-based VC-backed companies plummeted by 60%, from 30 in 2015 to 12 in 2016. However, California was home to three of the four largest VC-backed IPOs by US issuers in 2016—Nutanix ($238 million), Twilio ($150 million) and Coupa Software ($133 million).

M&A activity was essentially flat, with 224 reported acquisitions of California VC-backed companies, compared to 228 in 2015. The year's largest deals were AbbVie's acquisition of Stemcentrx for $5.80 billion (plus potential milestone payments of $4.0 billion) and Symantec's $4.65 billion acquisition of Blue Coat Systems.

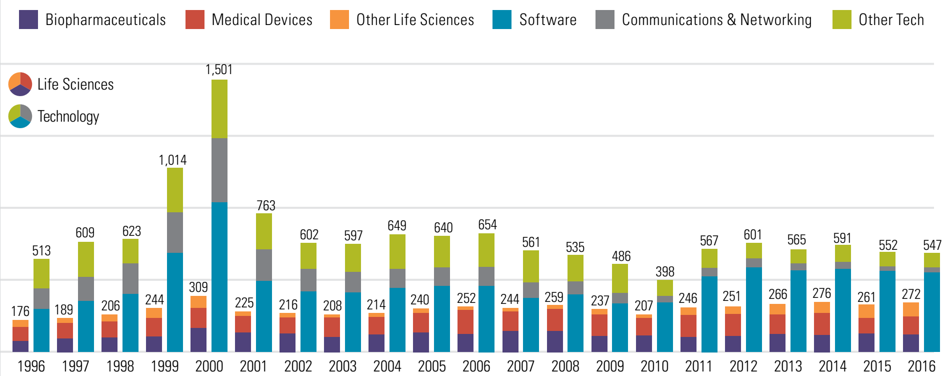
California will undoubtedly maintain its venture capital leadership in the coming year. Financing and liquidity activity in 2017 will largely depend on the level of venture capital fundraising, the extent to which strategic buyers continue to scale back the premiums they are willing to pay, and the timing and extent of improvement in IPO market conditions.

California Venture Capital Financings – 1996 to 2016



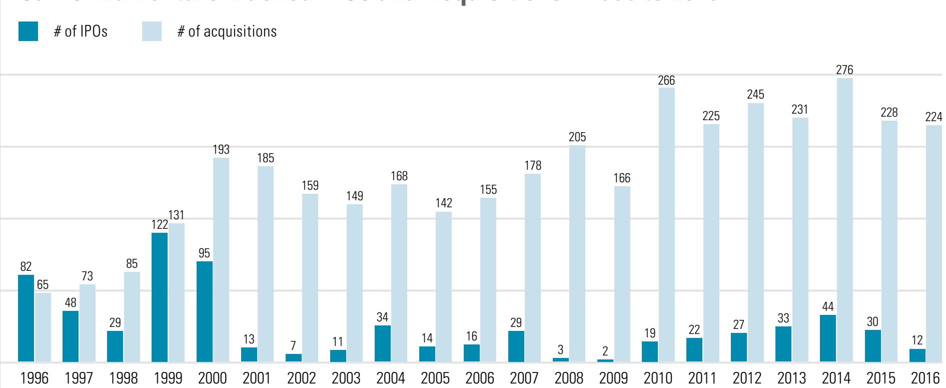
Source: Dow Jones VentureSource

California Venture Capital Financings by Selected Industry – 1996 to 2016



Source: Dow Jones VentureSource

California Venture-Backed IPOs and Acquisitions – 1996 to 2016



Source: Dow Jones VentureSource

MID-ATLANTIC

The number of reported venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia dropped by 9%, to 167 in 2016 from 183 in 2015. Much of this decline is likely to be erased after all of the year's deals are reported.

Total gross proceeds in the region fell 35%, from $2.58 billion in 2015—boosted by a trio of financings rounds of $200 million or more—to $1.68 billion in 2016.

The number of financing rounds raising $50 million or more fell from nine in 2015 to four in 2016. The region's largest financings in 2016 were by Snagajob ($100 million) and Phononic ($71 million).

Technology companies accounted for 36% of all mid-Atlantic financings in 2016, followed by business and financial services companies (28%) and life sciences companies (25%).

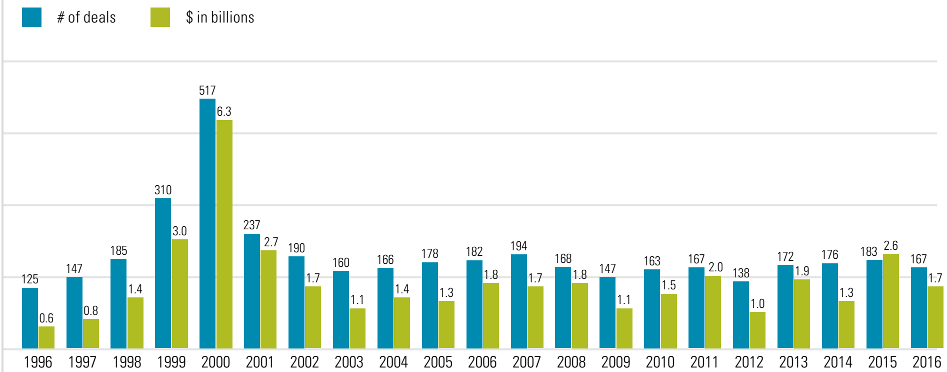
The mid-Atlantic region produced only a pair of VC-backed IPOs in 2016. Pharmaceutical company Novan, based in North Carolina, and medical technology company Senseonics, based in Maryland, each completed a $45 million IPO. The year's IPO tally was the region's lowest annual figure since 2011, and represented its third consecutive year of declining IPO activity.

The number of reported acquisitions of mid-Atlantic VC-backed companies declined by 43%, from 42 in 2015 to 24 in 2016. Virginia generated eight deals, followed by Maryland (six), North Carolina (five), the District of Columbia (three) and Delaware (two).

The region's largest M&A transactions of the year were the $275 million acquisition of TradeKing by Ally Financial and the $150 million acquisition of Bamboo Therapeutics by Pfizer.

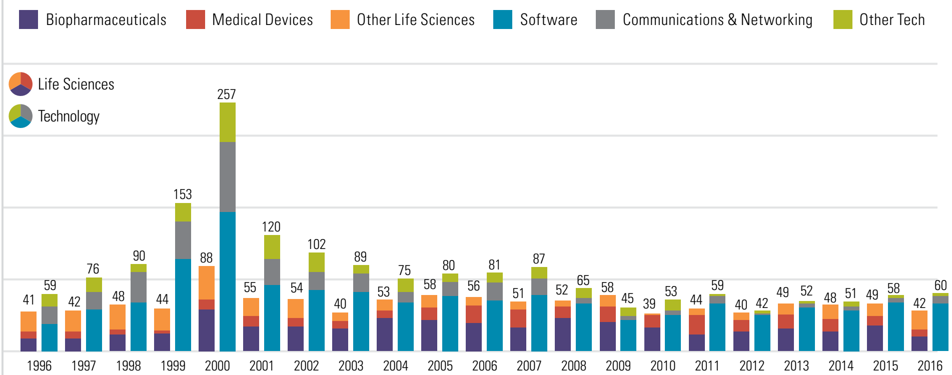
Assuming market conditions are conducive, the mid-Atlantic region should see an uptick in financing activity and liquidity events by VC-backed companies in 2017, led by the technology and life sciences sectors.

Mid-Atlantic Venture Capital Financings – 1996 to 2016



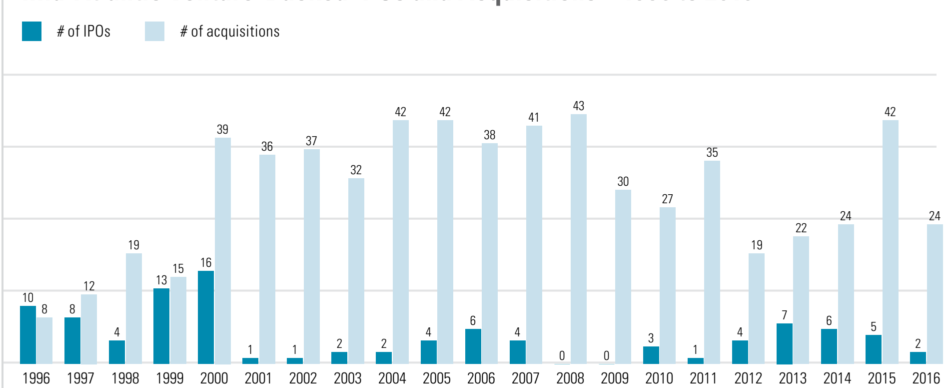
Source: Dow Jones VentureSource

Mid-Atlantic Venture Capital Financings by Selected Industry – 1996 to 2016



Source: Dow Jones VentureSource

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1996 to 2016



Source: Dow Jones VentureSource

NEW ENGLAND

New England companies reported 329 venture capital financings in 2016, down 19% from 407 financings in 2015. Although this decline is partially due to delayed reporting, it is unlikely to be reversed even after all deals are reported.

Total financing proceeds in New England fell by 30%, from $7.55 billion in 2015 to $5.26 billion in 2016. Despite this drop, the 2016 figure still represents the second-highest annual gross proceeds figure in the region since 2000.

The number of rounds raising $50 million or more declined from 35 in 2015 to 24 in 2016. For the second year in a row, the region's largest financings came from Moderna Therapeutics ($474 million) and Intarcia Therapeutics ($421 million).

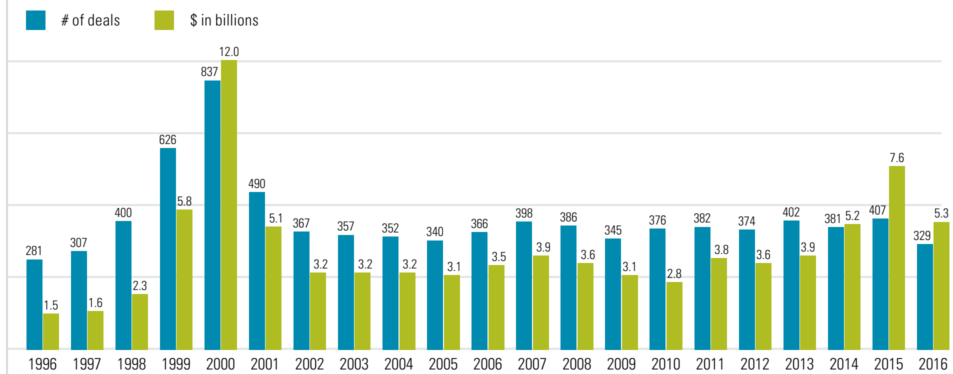
For the eighth consecutive year, life sciences companies led the region in financing activity. The life sciences sector represented 35% of New England's venture capital financings, followed by technology (30%), and business and financial services (21%).

The number of venture-backed IPOs by New England–based companies dropped from 12 in 2015 to nine in 2016. All hailed from Massachusetts, with life sciences companies accounting for all but two. The largest VC-backed IPOs were by Intellia Therapeutics ($108 million) and Acacia Communications ($104 million)—Acacia produced the nation's best-performing IPO of 2016, ending the year 168% above its offering price.

The number of reported acquisitions of VC-backed companies in New England declined 9%, from 55 in 2015 to 50 in 2016, of which Massachusetts contributed 39. The region's largest M&A transaction of the year was the $700 million acquisition of Seventh Generation by Unilever.

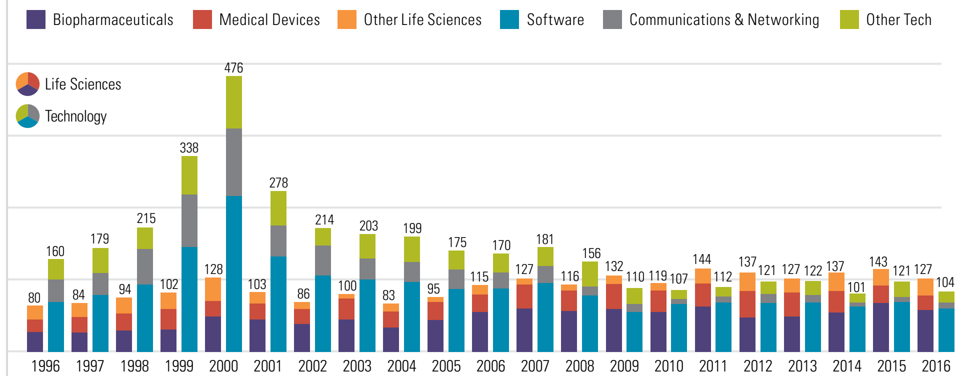
With its concentration of world-renowned universities and research institutions, New England—and Massachusetts in particular—should remain one of the country's most appealing environments for emerging companies and a hub of venture capital and IPO activity during 2017, particularly in the life sciences and technology sectors.

New England Venture Capital Financings – 1996 to 2016



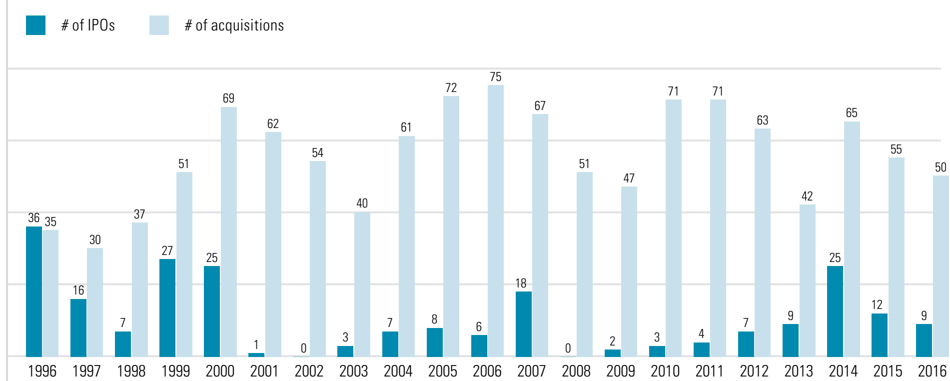
Source: Dow Jones VentureSource

New England Venture Capital Financings by Selected Industry – 1996 to 2016



Source: Dow Jones VentureSource

New England Venture-Backed IPOs and Acquisitions – 1996 to 2016



Source: Dow Jones VentureSource

TRI-STATE

The number of reported venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania declined by 11%, from 625 in 2015 to 558 in 2016. New York led the region with 442 financings in 2016 to remain the nation's second-largest source of VC financings.

Total proceeds in the region decreased 28%, from $8.87 billion in 2015 to $6.37 billion in 2016. Financing proceeds from New York–based companies were $5.67 billion, representing 89% of the region's total.

WeWork attracted the region's largest financing for the second year in a row, with a $430 million round, followed by Oscar Insurance ($400 million) and Payoneer ($180 million).

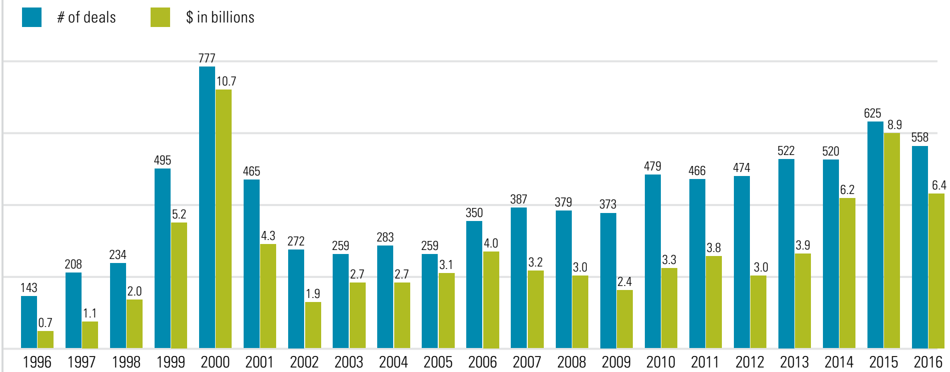
Consumer services companies accounted for the largest share of the tri-state region's VC financing activity in 2016, with 30% of all financings, followed by technology companies with 28% and life sciences companies with 15%.

The number of VC-backed IPOs in the tri-state region declined from seven in 2015 to three in 2016. The region's largest VC-backed IPOs were by New York–based Kadmon ($75 million) and two New Jersey–based companies, Tabula Rasa HealthCare ($52 million) and Oncobiologics ($35 million).

Reported acquisitions of venture-backed companies in the tri-state region increased by 7%, from 82 in 2015 to 88 in 2016. New York generated 64 deals, followed by Pennsylvania (18) and New Jersey (6). The region's largest deal of 2016 was the $3.3 billion acquisition of Jet.com by Walmart. Other prominent deals included the $1.2 billion acquisition of IT Cosmetics by L'Oréal, and the acquisition of Gilt Groupe by Hudson's Bay Company for $250 million.

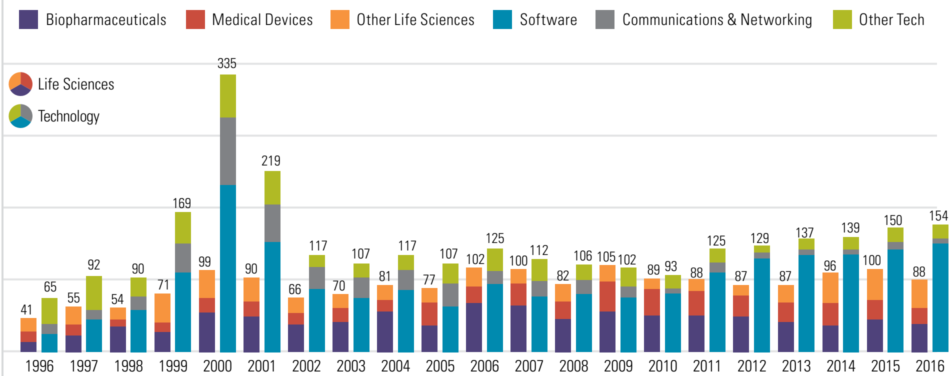
Led by the consumer services, technology and life sciences sectors, the tri-state region should see continued strength in venture capital financing and acquisition activity in 2017, as well as a rebound in VC-backed IPOs if market conditions are conducive. ■

Tri-State Venture Capital Financings – 1996 to 2016



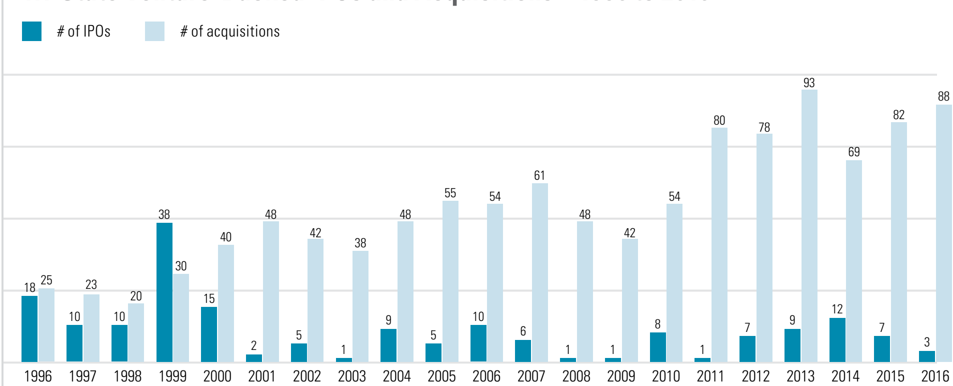
Source: Dow Jones VentureSource

Tri-State Venture Capital Financings by Selected Industry – 1996 to 2016



Source: Dow Jones VentureSource

Tri-State Venture-Backed IPOs and Acquisitions – 1996 to 2016



Source: Dow Jones VentureSource

WHY ARE THESE PLANS NEEDED?

The uneven economy and choppy IPO market of recent years have created a challenging environment for venture capital–backed companies. Many of these companies are finding it takes longer than initially planned to generate revenue traction or to attain cash flow breakeven, causing them to raise more funding than originally anticipated and resulting in large liquidation preferences. Moreover, if a company must raise funds at a time when its business is not clicking on all cylinders, the result is often a "down round"—a financing at a lower price than the previous financing round—which not only adds to the total liquidation preference, but also significantly dilutes the equity holdings of the management team, eroding the retention and incentive value of management equity plans.

One approach to address this situation is a so-called "management carve-out plan." Such a plan provides that, upon an acquisition of the company, instead of allocating the purchase price among company stockholders strictly in the manner provided for in the corporate charter (which might result in little or none of the proceeds being allocated to common stockholders and option holders), a portion of the acquisition price is paid directly to plan participants, with the balance allocated in the manner the charter provides.

BASIC TERMS

A company that wishes to implement a management carve-out plan must address a number of often-complicated issues.

The first set of issues relates to participation in the plan:

- Who will be the participants—all employees, or only management?
- Are participants selected and economic interests in the plan allocated at the time the plan is implemented or at the time the company is sold? The former approach should be a more effective retention and recruiting tool since employees can be assured of some type of payoff upon a sale of the company, while the latter approach provides more flexibility to the board of directors to reward those employees who contribute the most to the company through the time of sale and can avoid some legal and tax complexities.
- Do plan participants' interests vest over time?
- If participants in the plan are designated at the time of implementation, do they lose their participation rights if they leave the company prior to a sale? If so, what happens to the forfeited interests—do they automatically accrue pro rata to the benefit of the other participants, or is the total payoff to plan participants instead reduced?

The second group of issues involves the determination of the amount to be paid to plan participants:

- Is the payment a fixed amount or based on the sale price? Is there a cap on the amount paid under the plan?
- If the payment is based on the sale price, how is the sale price determined for this purpose? Is it the gross sale price or the net price after transaction expenses? How are earnouts and escrows accounted for? What about assumed or retained liabilities (including company taxes), or company wind-down expenses?
- Does the payment accrue from the first dollar, or apply only above a minimum sale price (to avoid rewarding employees for a sale at an unattractive price) and/or below a maximum sale price (because at a higher sale price the employee's equity interest becomes valuable again and the carve-out plan is not necessary or the level of compensation due creates a barrier to the buyer's retention efforts)?
- What is the payment timing? In an asset sale, what if the company needs to retain a portion of the sale proceeds for a period of time to satisfy contingent obligations?
- Is the payment made in cash, or in the form of the consideration (including stock) paid by the buyer?
- Is the amount payable to participants reduced by the value received for their equity interests in the acquisition of the company?

POSSIBLE STRUCTURES

Described below are four common structures for a management carve-out plan, and the principal advantages and disadvantages of each one.

Alternative One

Establish a cash bonus plan or enter into an agreement with individual employees providing for a cash payment upon an acquisition.

Primary advantages:

- It is simple to implement—stockholder approval is typically not required, and no new securities are issued.
- Participation in the plan can be limited to specific persons (such as key employees) and subject to certain conditions (such as remaining employed through the sale's closing or beyond).
- It does not require any payments by plan participants.

	Alternative One	Alternative Two	Alternative Three	Alternative Four
Ease of implementation	Simple	Complicated (charter amendment may be required)	Complicated (charter amendment required)	Very complicated (charter amendment required)
Plan participation	Flexible	Flexible	Inflexible	Flexible
Payments by participants	No	No	No	Yes
Acquiring company forced to pay some cash	Yes	No	No	No
Tax-deferred treatment possible	No	No	Yes	Yes
Capital gains possible	No	No	Yes	Yes

Primary disadvantages:

- In effect, it forces the buyer to pay a portion of the acquisition price in cash (to fund the payments under the plan), even if the buyer wishes to use stock for the acquisition.
- The payments to plan participants are taxable as ordinary income, not capital gains.

Alternative Two

Establish a plan providing for the payment of a portion of the acquisition price to plan participants, often in the form of the consideration paid by the buyer.

Primary advantages:

- Participation in the plan can be limited to specific persons (such as key employees) and subject to certain conditions (such as remaining employed through the sale's closing or beyond).
- It does not require any payments by plan participants.
- It does not force the buyer to pay a portion of the acquisition price in cash.

Primary disadvantages:

- This approach is harder to implement than alternative one. For example, it may require a charter amendment to provide that payments under the plan do not contravene the preferred stock liquidation preferences.
- The payments to plan participants are taxable at the time of receipt, even in a tax-free acquisition and even if the payments are in the form of stock that cannot be immediately sold.
- The payments under the plan are taxed as ordinary income, not capital gains.

Alternative Three

Amend the terms of the company's charter to provide that a percentage of the proceeds of an acquisition is paid to the holders of common stock (and, possibly, option holders) on a *pari passu* basis with the payments to the holders of preferred stock in respect of their liquidation preferences.

Primary advantages:

- It does not require any additional payments by plan participants (typically holders of common stock and options).
- It does not force the buyer to pay a portion of the acquisition price in cash.
- If the acquisition is structured as tax-free, the plan participants will share in that benefit.
- In a taxable acquisition, the payments to plan participants would typically be treated as capital gains (rather than ordinary income), which would be long-term if the common stock has been held for more than one year.

Primary disadvantages:

- Payments are shared on a pro rata basis by all holders (including non-employees) of common stock and options and cannot be directed solely or disproportionately to contributing employees.
- Implementing this approach requires a charter amendment.

Alternative Four

Create and issue a new class of stock, the terms of which provide for the payment of a certain portion of the proceeds of an acquisition of the company to the holders of that class of stock.

Primary advantages:

- Participation in the plan can be limited to specific persons (such as key employees) and subject to certain conditions (such as remaining employed through the sale's closing or beyond).
- It does not force the buyer to pay a portion of the acquisition price in cash.
- If the acquisition is structured as tax-free, the plan participants will share in that benefit.
- In a taxable acquisition, the payments to plan participants would typically be treated as capital gains (not ordinary income), which would be long-term if the new stock has been held for more than one year.

Primary disadvantages:

- It is complex to structure and implement.
- Plan participants must either pay for the new stock or incur taxable income upon receiving the stock if it is issued without consideration. Moreover, because the terms of this class of stock include a liquidation preference that effectively guarantees some payment upon an acquisition, the fair market value of this stock (which would either be paid by plan participants or recognized as taxable income) is generally not as low as the fair market value of ordinary common stock.

A company contemplating a management carve-out plan should carefully consider each of the four approaches to determine which is best suited for its particular needs.

OTHER ISSUES

Depending on how it is structured, a management carve-out plan can raise a number of other legal and tax issues, such as:

- Whether the plan raises issues under Section 280G (parachute payment provisions) or Section 409A (deferred compensation provisions), or poses ERISA concerns.
- Whether the implementation of the plan is consistent with the fiduciary duties of the board of directors.
- What consents or waivers are required to implement the plan, such as stockholder approval of a charter amendment, the waiver of anti-dilution provisions and the waiver of preemptive rights.

CONCLUSION

Management carve-out plans can be complicated to implement because they often involve difficult choices with respect to the terms and structure of the plan and challenging legal issues. However, when properly structured and implemented, a management carve-out plan can go a long way toward addressing a fundamental problem many venture-backed companies face. ■

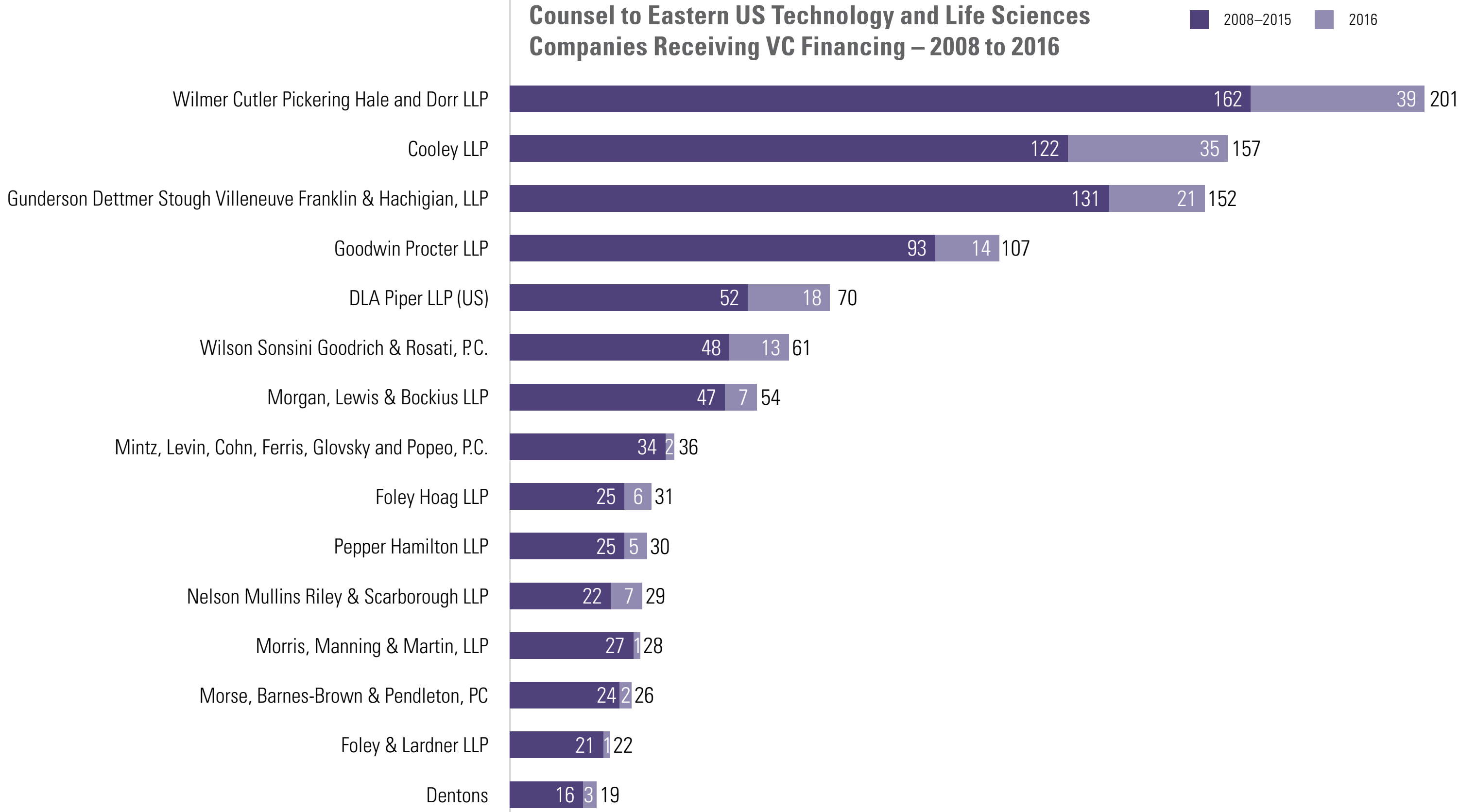
Counsel of Choice for Venture Capital Financings

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, ENERGY AND CLEANTECH, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND

Denali Therapeutics	$130,000,000	*Second Round*	June 2016
Soft Robotics	$8,000,000	*First Round*	December 2016
1366 Technologies	$25,000,000	*Late Stage*	May 2016
Deciphera	$90,000,000	*Second Round*	December 2015
Syros Pharmaceuticals	$40,000,000	*Late Stage*	January 2016
Accion Systems	$7,500,000	*First Round*	April 2016
Kala Pharmaceuticals	$68,000,000	*Third Round*	April 2016
Altiostar	$60,000,000	*Late Stage*	September 2016
Fulcrum Therapeutics	$55,000,000	*First Round*	July 2016
BarkBox	$60,000,000	*Late Stage*	May 2016
Spoiler Alert	$2,500,000	*First Round*	November 2016
Constellation Pharmaceuticals	$55,000,000	*Late Stage*	December 2015
Cape Analytics	$14,000,000	*First Round*	May 2016
kite hill	$18,000,000	*Second Round*	May 2016
Nantero	$21,000,000	*Late Stage*	December 2016
Civis Analytics	$22,000,000	*First Round*	August 2016
TransMedics	$51,200,000	*Late Stage*	May 2016
DroneTracker	$15,000,000	*Second Round*	February 2017
BlinkBio	$11,000,000	*First Round*	September 2016
Vtesse	$17,000,000	*First Round*	July 2016
DataXu Data. Insight. Action.	$10,000,000	*Late Stage*	January 2016
Lexigram	$2,000,000	*First Round*	August 2016
Quilt	$3,250,000	*First Round*	April 2016
themuse	$16,000,000	*Second Round*	June 2016
ribon therapeutics	$23,500,000	*First Round*	November 2016
Blue Apron	$135,000,000	*Fourth Round*	May 2015
SyncOnSet	$1,500,000	*Second Round*	November 2016
Zaius	$8,000,000	*Second Round*	April 2016
Apellis	$47,000,000	*Fourth Round*	December 2015
	$5,000,000	*First Round*	August 2016
Andela	$24,000,000	*Second Round*	May 2016
Visterra	$23,100,000	*Third Round*	June 2016

WilmerHale®

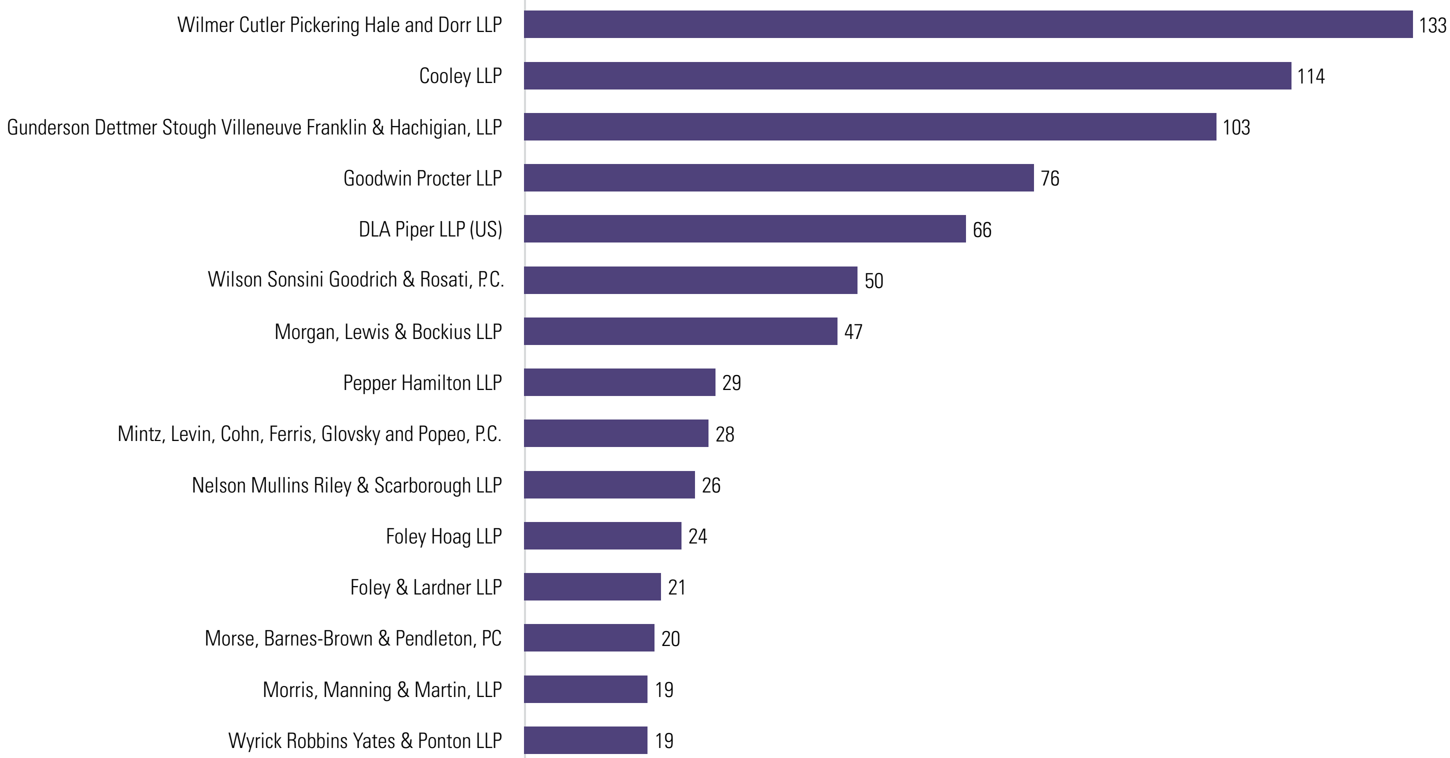
Counsel to Eastern US Technology and Life Sciences Companies Receiving VC Financing – 2008 to 2016



The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later-stage or restart round of venture capital financing between 2008 and 2016.

Source: Dow Jones VentureSource

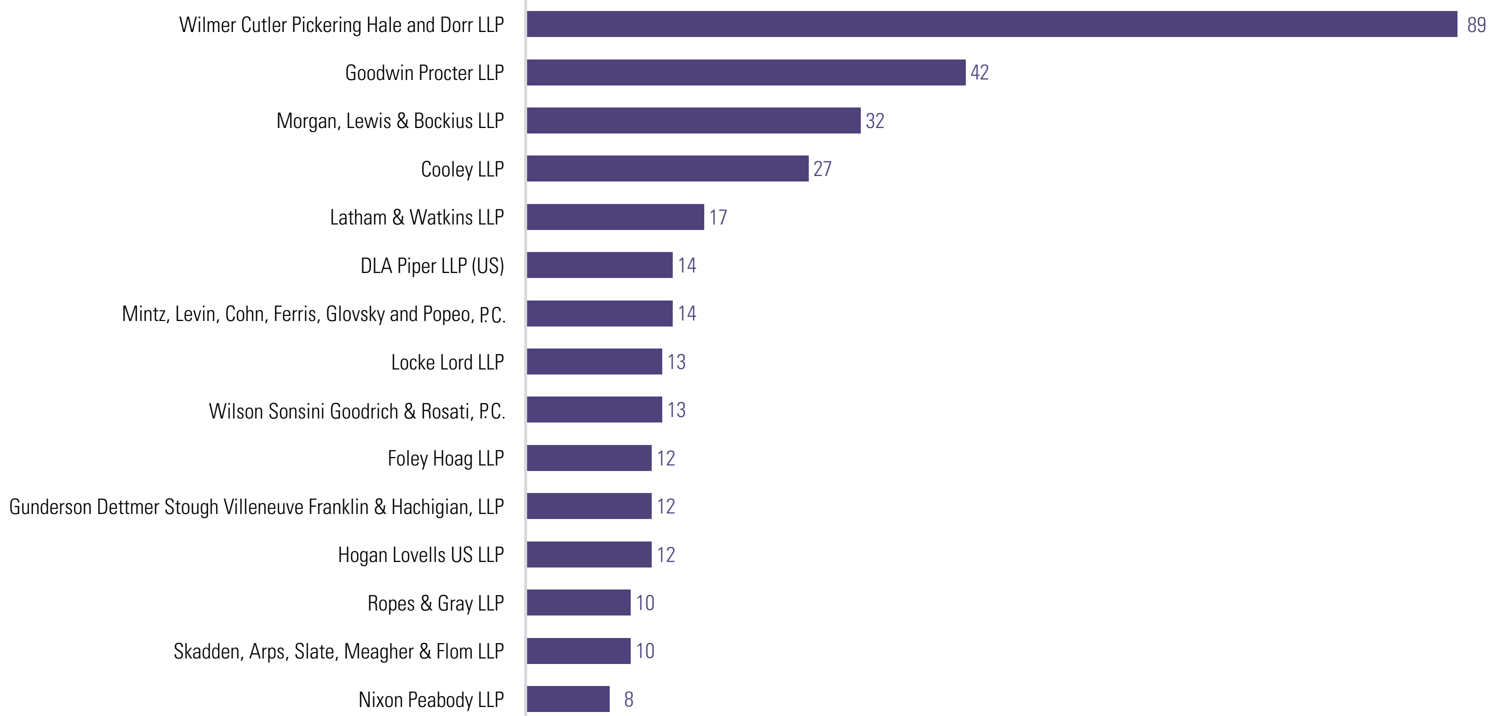
Counsel to Eastern US VC-Backed Technology and Life Sciences Companies at Year-End 2016



The above chart is based on VC-backed companies located east of the Mississippi River that were private and independent as of the end of 2016.

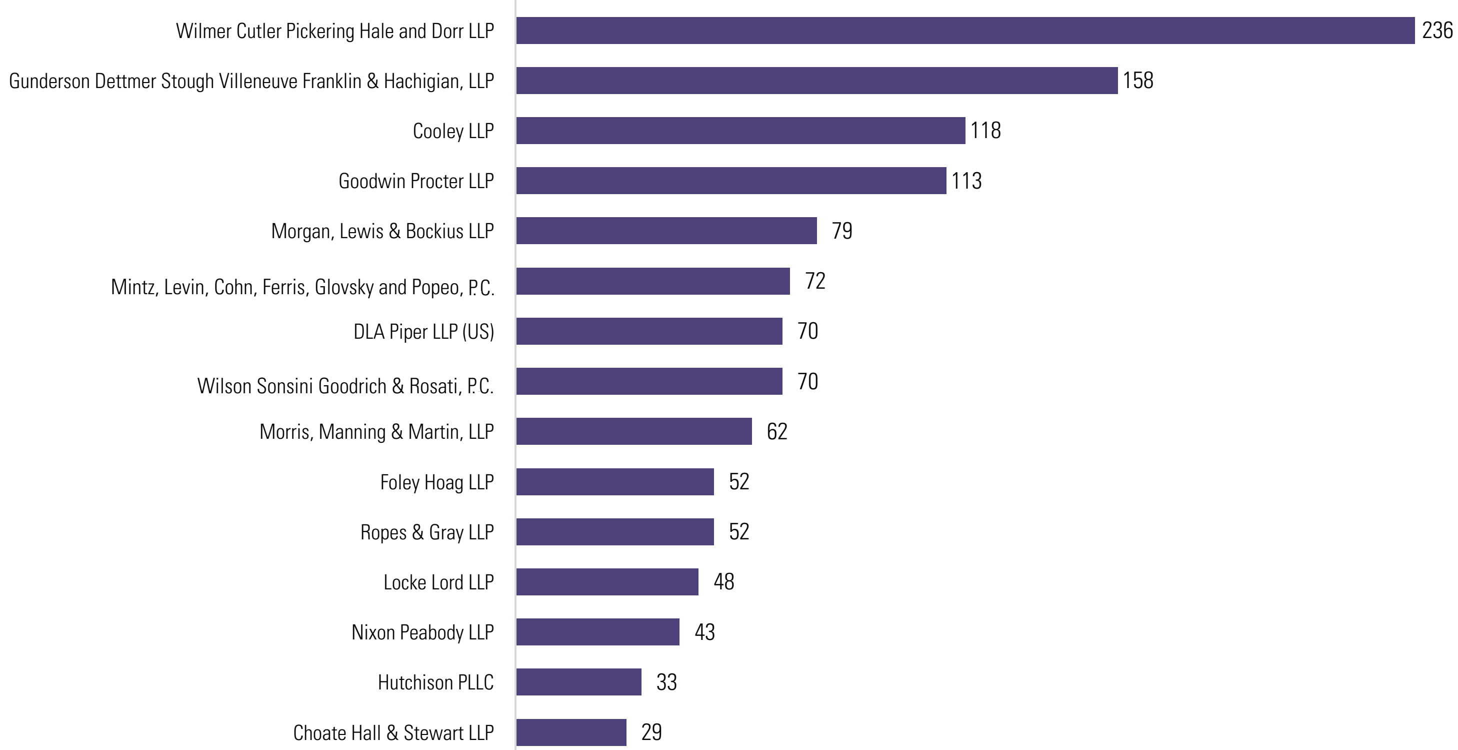
Source: Dow Jones VentureSource

Company Counsel in Eastern US VC-Backed IPOs – 1996 to 2016



The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureSource and SEC filings

Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2016



The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureSource

In order to avoid a violation of Section 409A of the Internal Revenue Code, an option must be granted with an exercise price that is at least equal to the fair market value of the underlying stock on the option grant date (generally, the date the option is approved by the company's board of directors). If the board of directors determines the fair market value of the company's stock underlying the option in a manner consistent with one of the safe harbor methods provided under Section 409A—typically, by obtaining an independent appraisal—the fair market value determination will be presumed to be reasonable by the IRS.

In the following Q&A, we describe certain rules under Section 409A related to stock options, and provide best practices for a private company setting option exercise prices in light of those rules.

Q1: What is Section 409A?

Section 409A applies to any compensation that is granted or earned in one tax year, but that could be paid in a later tax year. The Section 409A rules are drafted so broadly that, unless a specific exemption applies, all sorts of compensatory arrangements, including employment agreements, severance arrangements and equity awards, are caught in Section 409A's net.

Q2: Does Section 409A apply to options?

Yes, unless the option qualifies for an exemption under the Section 409A rules.

Incentive stock options (ISOs) are exempt from Section 409A. However, in order to be a valid ISO, an option must, among other requirements imposed by the Internal Revenue Code, be granted with an exercise price equal to (or greater than) the fair market value of the underlying stock on the grant date. An option that doesn't meet all ISO requirements is automatically treated as an nonstatutory stock option.

Nonstatutory stock options (also known as nonqualified stock options, or NSOs) may also be exempt from Section 409A, if, among other requirements, (1) the option exercise price is never less than the fair market value of the underlying stock on the option grant date and (2) the number of shares subject to the option is fixed on the date of grant.

Q3: So, regardless of whether an option is intended to be an ISO or an NSO, it must be granted with an exercise price equal to (or greater than) the fair market value of the underlying stock on the grant date, in order to be exempt from Section 409A?

Yes. Discounted options—options with an exercise price that is less than the fair market value of the underlying stock on the grant date—will always be subject to Section 409A. And if the option holder can choose, after any vesting requirements have been satisfied, when to exercise the discounted option, then the option will violate Section 409A.

Q4: What happens if an option violates Section 409A? That is, what if we grant a discounted option and allow the option holder to exercise any time during the term of the option once it is vested?

It's not pretty. If an option is not exempt from or compliant with the rules under Section 409A, then Section 409A accelerates the taxation of the option to the time the option vests and imposes a 20% penalty tax on the income recognized at that time, in addition to all applicable regular federal and state taxes. (Note that some states, most notably California, impose their own, additional, 409A penalty tax as well.) In addition, any appreciation in the value of the stock after the vesting of the option is taxed annually at regular federal and state rates, plus a 20% penalty tax and special Section 409A interest charges, until the option is either exercised or expires. So, the option holder is required to pay taxes—lots of taxes—without having received marketable equity or cash. Set forth at the end of this article is an example of just how onerous this tax treatment is.

For more on how a non–409A exempt option could comply with Section 409A, see Q15 below.

Q5: Do all the adverse tax consequences of a Section 409A violation fall on the option holder?

For the most part, yes. Section 409A imposes the penalty taxes (and additional interest charges) on the option holder (even though he or she likely had nothing to do with how the exercise price of the grant was determined).

However, while the tax liability is imposed on the individual, the company must withhold the federal and state income taxes on the income recognized at vesting (but not the penalty tax or interest charges) and comply with certain reporting obligations.

In addition, Section 409A issues can become problematic for the company at the time of an acquisition or an IPO. Section 409A is very much on the radar of potential acquirors and due diligence in an acquisition routinely involves reviewing option grant practices, including how the exercise price was determined. Acquirors typically insist that sellers address any clear or potential Section 409A violations, including the setting of option exercise prices, through restructuring or cancellation of options or through special indemnification provisions or gross-ups for option holders. After all, acquirors are keenly focused on positive employee relations going forward. Knowing the correct fair market value is also necessary to properly determine and reflect accounting charges for options in the company's financial statements. This becomes particularly important at the time of an IPO when the SEC reviews compensation charges taken for options granted in the period leading up to the IPO. While it is not required that the same fair market value of the stock be used for both tax purposes and accounting purposes, to the extent that the company's accountants require the company to use a fair market value of the stock as of the grant date that is greater than the option exercise price, there would be a red flag for both taxing authorities and acquirors regarding the company's option granting practices. For these reasons, it is very much in the company's interest—as well as the option holder's—to get the valuation right.

Q6: OK, we want our options to be exempt from Section 409A. Who establishes what "fair market value" is?

The company's board of directors.

Q7: And what is the relevant date for determining what "fair market value" is?

To be exempt from Section 409A, the option must have an exercise price equal to the fair market value of the underlying common stock on the grant date, which is generally the date the company's board of directors approves of the grant.

Q8: You said the grant date is "generally the date the company's board of directors approves of the grant." Can it be another date?

An option is considered granted when a duly authorized body (i.e., the board of directors, its compensation committee or an officer to whom the ability to grant options has been properly delegated) completes the last corporate action to effect the option grant, either via approving resolutions at a meeting or completing a unanimous written consent. The resolution or consent must include: (1) the name of the recipient of the option, (2) the number of shares of the company's stock to be covered by the option, and (3) the option's exercise price. Because this typically occurs on the date that the board of directors approves the grant of the options, we say that the grant date is the date the grant is approved by the board of directors. Note, however, that when a unanimous written consent is used to approve option grants, the grant date is the date that the last consent is received by the company.

Q9: Does that mean vesting must also begin on the date the option is approved by the board of directors?

No. The date vesting begins can be any date and is unrelated to the determination of the option's exercise price. For example, the vesting commencement date for a new hire option grant can be the employee's date of hire even if the option is approved by the board weeks or months later. In addition, the board may decide to accelerate the vesting of an option at any time, without any impact on how the option is treated for purposes of 409A.

Q10: How does the board of directors establish "fair market value"?

The regulations under Section 409A state that, for privately held companies, the fair market value of the stock underlying a stock option is the value determined by "the reasonable application of a reasonable valuation method." Whether or not a valuation is reasonable is determined based on all the relevant facts and circumstances; however, the regulations stipulate that factors to be considered in a reasonable valuation method include:

- the value of tangible and intangible assets of the company;
- discounted cash flows;
- values of comparable companies;
- recent transactions in the stock;
- control premiums and discounts for lack of marketability; and
- whether the valuation is used for any other purpose that would have a material economic effect on the company, its stockholders or its creditors.

Essentially, all qualitative and quantitative factors bearing on valuation must be considered each time the valuation will be used to set the exercise price of an option.

Happily, the Section 409A regulations provide valuation safe harbors that are much less amorphous and that, if used, give any fair market value determination made by a company's board of directors a presumption of reasonableness. This means that if the IRS were to challenge the fair market value determined by the board, the IRS would have to prove that the value was "grossly unreasonable." (By contrast, if the board did not use a valuation safe harbor, then, if contested by the IRS, the company would bear the burden of proving that, based on all the facts and circumstances on the valuation date, the valuation was reasonable.)

Q11: What are the Section 409A valuation safe harbors?

The most commonly used valuation safe harbor allows a board of directors to base its fair market value determination on an independent valuation of the company's stock performed by a qualified appraiser. Such a valuation can be relied upon for up to 12 months from the valuation effective date (as opposed to the date the report is received by the company) unless its later use would be grossly unreasonable. No guidance yet exists on how to apply this standard. However, it is advisable to obtain a new valuation prior to the end of the 12-month period if the company achieves a significant milestone. In fact, if the company expects to complete an IPO in the next 12 to 18 months, quarterly valuation updates are generally appropriate.

A second valuation safe harbor allows the board of directors of a startup corporation (generally, a privately held corporation that has been in existence for less than 10 years) to base its fair market value determination on a valuation made reasonably and in good faith and evidenced by a written report that takes into account the same factors that an independent appraiser would consider, as set forth in Q10 above. This valuation can be done in-house but must be performed by someone who is qualified to perform the valuation because of his or her significant knowledge, experience (i.e., at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending or comparable experience in the company's line of business or industry), education or training. Nor will the safe harbor apply if the company "reasonably anticipates" as of the date of the valuation that it will have a change in control within 90 days of the valuation date or make a public offering of securities within 180 days of the valuation date.

Q12: Which safe harbor is best for us?

Ultimately that's for the company's board of directors to decide. If the board complies with the requirements of either safe harbor, the presumption of reasonableness will attach to its determination of fair market value. That said, most pre-funded companies do not have someone in-house with the required expertise to perform the startup corporation valuation in accordance with the requirements of the Section 409A regulations. And funded companies tend to prefer the convenience of hiring a third-party independent appraiser to conduct the valuation. Because of this, most companies rely on the independent valuation safe harbor.

Q13: How much does getting an independent appraiser to do a valuation cost and how long does it take?

Generally, a Section 409A valuation will cost between $3,000 and $10,000 and take about four to eight weeks to complete.

Q14: Can our board delegate to our CEO the authority to make option grants to our new hires based on a good Section 409A valuation determined at our board's last meeting?

If there is a proper delegation of granting authority that is permitted by the equity plan and that complies with applicable state corporate law, your CEO may grant equity awards within the parameters of his or her authority. However, if the CEO is granting options, then he or she must make an assessment of the fair market value of the underlying stock on each option grant date. Reliance on the board's previous determination of fair market value alone is not sufficient. Even if the CEO does make his or her own valuation determination, the risk is that the board may conclude at the next board meeting that there has been an increase in the fair market value of the company's stock. This would throw into question whether the option granted by the CEO has a fair market value exercise price. If it is determined that the increase in stock price occurred before the CEO granted the option, then the option would violate Section 409A. Instead, best practice would be to have the board of directors approve all hire grants to all employees who started with the company since the date of the last board meeting. The vesting period, as described in Q9, can still be tied back to the option holder's first day of employment or service (or an earlier date, as applicable).

Q15: Is there any way to grant a discounted option that does not create a Section 409A violation?

Yes, but such options are very unusual. To avoid a violation of Section 409A, a discounted option must comply with strict Section 409A rules relating to how and when the option can be exercised. This compliance eliminates the option holder's ability to choose when to exercise his or her option and, as such, is a much less attractive (and, consequently, less effective) form of compensation.

Section 409A–compliant options may only be exercised upon any one of six permitted events (in each case, as defined under Section 409A) that are selected at the time of grant: separation from service, death, disability, an unforeseeable emergency, a change in control, or a specified time or on a fixed schedule. Once a Section 409A–compliant option has been granted and the exercise events selected, it cannot be amended and the exercise date cannot be accelerated or deferred, except in very limited circumstances.

Q16: This is all about options. Do the same rules apply to awards of restricted stock?

No. Awards of restricted stock are not subject to Section 409A. ■

EXAMPLE OF TAX TREATMENT OF NON–SECTION 409A-COMPLIANT OPTION GRANT

Assume an option to purchase 100,000 shares of common stock with a fair market value of $1.00 per share is granted to an employee on December 31, 2016 with an exercise price of $0.50 per share. The option vests in four equal installments on each December 31 thereafter until the option is fully vested on December 31, 2020. The fair market value of the underlying stock is $1.10 on December 31, 2017, $1.20 on December 31, 2018, $1.50 on December 31, 2019, and $2.00 on December 31, 2020.[1]

Based on this fact pattern, the option holder must include amounts in income each year as his or her option vests and pay additional penalty taxes on those amounts.

VEST DATE	INCLUDIBLE INCOME	TAX (ASSUMING AN EFFECTIVE TAX RATE OF 65%)*
12/31/2017	$15,000 (i.e., the spread on the vested portion of the option as of 12/31/2017)	$9,750
12/31/2018	$20,000 (i.e., the spread on the vested portion of the option as of 12/31/2018 less the amount included in income in 2017)	$13,000
12/31/2019	$40,000 (i.e., the spread on the vested portion of the option as of 12/31/2019 less the amounts included in income in 2017 and 2018)	$26,000
12/31/2020	$75,000 (i.e., the spread on the vested portion of the option as of 12/31/2020 less the amounts included in income in 2017, 2018 and 2019)	$48,750
Total	$150,000	$97,500

* *Does not include any interest or penalties other than the federal Section 409A 20% penalty tax*

By contrast, if the option described above had been an NSO granted with an exercise price of $1.00 per share, there would be no income on each vesting date. Instead, assuming the NSO was exercised on December 31, 2020, the option holder would have income equal to $150,000 which would be subject to tax at an effective rate of 45% such that the option holder would pay only $67,500 in taxes.

1 *For purposes of this example, we have assumed that the stock price steadily increases over time. The Section 409A rules that address what happens when the fair market value of stock underlying an option that violates Section 409A fluctuates or subsequently decreases are particularly complex. However, it is worth noting that under those rules, a holder may not be made completely whole in situations where Section 409A requires income inclusion for amounts that are ultimately never received by the option holder.*

A total of $8.57 billion was invested across 1,299 Series A investments in the United States in 2016, according to VentureSource. The amount invested in Series A rounds has been trending upwards over the last few years. Despite this upswing in proceeds, however, the total number of Series A deals is on the decline. The last quarter of 2016 saw the lowest number of Series A deals since the first quarter of 2011. Fewer companies are successfully raising Series A rounds, but those that do are raising more money.

If you are planning to raise money in 2017, here are five things you should start doing now to improve your chances of success.

BUILD AND LEVERAGE YOUR NETWORK

Successful founders need to surround themselves with smart people who understand their industry and its challenges, and can offer the right guidance. These people add credibility to the company and the founding team, and can introduce you to investors and influencers. If you haven't been able to find well-connected, experienced advisors, you need to do so now.

Accelerators and incubators are generally very good at providing access to a network of mentors and investors. Social media—LinkedIn, Twitter and Facebook—has made it easier than ever for founders to directly engage with investors and key thought leaders. Another great way to grow your network is to attend startup-focused networking events.

As you build your network, you shouldn't only be focused on connecting with investors. It's also important to build relationships with other founders who have successfully raised money. Their experience can be invaluable in helping you decide which investors to target, and in identifying mistakes and potential pitfalls.

KNOW YOUR METRICS

One of the key factors investors will consider is whether founders are focused on achieving the right metrics for their business. It is easy to get carried away pursuing vanity metrics, but doing so while ignoring the "right" metrics can make or break your company. Look at comparable companies and plumb your network for insight on metrics.

ALIGN WITH CO-FOUNDERS

One of the most common reasons companies fail is a falling out among co-founders. Before you decide to raise funds, make sure you see eye-to-eye with your co-founders on the key issues that can derail a promising venture. What is each founder's long-term vision for the company? What does giving up control mean for the future of the company, the founders and their roles in the company? These are just some of the questions you need to discuss.

ACKNOWLEDGE AND PLAN FOR RISKS

Founders tend to be wildly optimistic when starting a company, but their aspirations should be grounded in reality. At each stage of development, founders must thoughtfully identify the top risks facing the future growth of their companies and implement strategies to mitigate them, be they market, product or regulatory risks. A founder who can inspire confidence in his or her company's ability to identify and tackle short-and long-term risks is more likely to raise funding from institutional investors.

GET MARKET AND CUSTOMER VALIDATION

Although seed and even pre-seed money is more readily available to startups today than in past years, the bar for a Series A round is now higher than ever before. A few years ago a pre-product company may have been able to raise a Series A round, but that is less likely today. A company should not only have a built-out product, but also proof that the product is, or at least has the potential to be, widely adopted by the market. Founders who have validated the fact that their products address a genuine need in the marketplace, have tested their go-to-market strategies, and have some proof that their strategies will work are the most likely to successfully raise a Series A round. ■

SEEING EYE-TO-EYE WITH YOUR CO-FOUNDERS

Before taking money, entrepreneurs need to be forthright about where they stand on the key issues that can derail a promising venture and devastate a partnership. Work through these questions with your co-founders, and you'll not only understand one another better, but you'll also be more likely to succeed together.

- *When do we sell?* Founders rightly focus on developing their enterprise, not preparing to let it go, so they often don't discuss when they'd be willing to sell. Put it out there. Level with your partners: Are we willing to sell at $50 million? How about $100 million? Ever? It's never too late to ask this question. You should revisit it every time you think about raising capital, and as your business evolves.
- *Does anyone want out now?* If you suspect that a co-founder's interest has waned or vanished over the past few months, talk it through. A round of funding can catapult your business to the next level—but it usually adds years to the probable exit horizon, which can make an already discontented partner feel trapped and even unhappier. Don't assume that everyone's ambitions and dreams are unchanging.
- *Are we willing to give up some control?* When you launch a business, it's all yours. When you take investors' dollars, you're giving them a measure of control of your operations and strategy. Unfortunately, founders often don't have much leverage in negotiating those terms because those with the gold usually make the rules. That's a bitter pill for some entrepreneurs to swallow, especially when they've toiled so long on a venture. Remember that future rounds rarely become less onerous.
- *Are we getting the best partner for our needs?* A round of investment typically fuels a wave of growth. Perhaps you and your co-founders would benefit from some outside help as you scale the business during this cycle of rapid expansion. If you think you'll need support—and most of us do—make sure your investor is willing and capable of providing it.

Since the passage of the Protecting Americans From Tax Hikes Act of 2015 (PATH Act), the formerly elusive exclusion provision of Section 1202 of the Internal Revenue Code—which permits non-corporate investors to exclude from federal taxable income a portion of the gain realized from the sale or exchange of "qualified small business stock" (QSB Stock) held for more than five years—has proven to be very attractive to non-corporate investors.

NOW AND THEN: EXCLUSION RATES UNDER SECTION 1202

Historically, Section 1202 generally provided an exclusion from federal taxable income for 50% of any gain realized from the sale or exchange of QSB Stock held for more than five years. This 50% exclusion was limited in several ways. First, the amount of gain eligible for the exclusion was subject to a cap equal to the greater of (1) $10 million, reduced by the amount of gain attributable to the issuer's stock already excluded under Section 1202 by the investor in prior tax years, and (2) 10 times the aggregate adjusted basis of all of the issuer's QSB Stock disposed of by the investor during the current tax year. Second, long-term capital gain from the sale or exchange of QSB Stock ineligible for the exclusion was subject to taxation at a maximum rate of 28%. And third, a portion (7%) of the gain excluded under Section 1202 was required to be included in income for alternative minimum tax (AMT) purposes.

However, legislation passed starting in 2009 progressively made the exclusion more attractive. For QSB Stock acquired after February 17, 2009, and before September 28, 2010, the amount of excludable gain was increased from 50% to 75%, although the same limitations that applied to the 50% exclusion remained in place. Legislation from 2010 through 2014 increased the exclusion rate to 100%, but only for QSB Stock acquired during limited periods.

The PATH Act, signed into law on December 18, 2015, permanently amended Section 1202 to provide for an exclusion of 100% for QSB Stock acquired on or after September 28, 2010, subject only to the cap described above. None of the excluded gain is includable in income for AMT purposes or treated as "net investment income" for purposes of the 3.8% net investment income tax (NIIT).

WHAT IS QSB STOCK?

Generally, stock is treated as QSB Stock only if all of the following requirements are satisfied:

- *The QSB Requirement.* As of the date of issuance, the issuer was a domestic C corporation and neither it nor any predecessor corporation had aggregate gross assets—generally, cash and the aggregate adjusted tax basis of any other property—in excess of $50 million at any time prior to or immediately after the issuance.
- *The Active Business Requirement.* During substantially all of the investor's holding period, the issuer must have used at least 80% (by value) of its assets in the active conduct of one or more "qualified trades or businesses." For this purpose:
  - A "qualified trade or business" is any trade or business except those explicitly identified by the statute. For example, any business where the issuer's principal asset is the reputation or skill of its employees is excluded.
  - For corporations that have been in existence for less than two years, assets held to meet the reasonable working capital needs of a qualified trade or business, or held for investment and reasonably expected to be used within two years to finance R&D or increase working capital, are treated as used in the active conduct of such business. Notably, for corporations that have been in existence for two years or more, such assets may be counted as used in the active conduct of a trade or business only to the extent they do not exceed 50% of the corporation's assets (based on value).
  - The issuer is not a special tax-advantaged entity (such as a RIC or REIT).
  - Generally, a corporation does not meet the active trade or business test for any period during which (1) more than 10% of the total value of its assets consists of real property not used in the active conduct of a trade or business, or (2) more than 10% of the value of its net assets consists of stock or securities in other corporations (excluding subsidiaries).
- *The Original Issuance Requirement.* Stock is required to have been acquired by the investor at its original issuance in exchange for cash or property (other than stock), or as compensation for services. Certain redemptions during the four-year period beginning two years before the issuance of what would otherwise qualify as QSB Stock may cause such stock not to qualify. Stock acquired in exchange for QSB Stock in a tax-free reorganization generally will continue to qualify as QSB Stock, but the gain excluded may be subject to a limit equal to the gain in the QSB Stock at the time of the reorganization. ■

The following table summarizes the effective tax rates (including the 3.8% NIIT, and assuming the investor is in the highest tax bracket) for QSB Stock gain depending on when the QSB Stock was acquired:

QSB STOCK ACQUIRED	EXCLUSION AVAILABLE	CAP ON ELIGIBLE GAIN	EFFECTIVE LONG-TERM CAPITAL GAINS RATE ON QSB STOCK GAIN	MAXIMUM EFFECTIVE AMT TAX RATE ON QSB STOCK GAIN
On or before 2/17/2009	50%	Yes	15.90%	16.88%
On or between 2/18/2009 and 9/27/2010	75%	Yes	7.95%	9.42%
On or after 9/28/2010	100%	Yes	0%	0%

We reviewed all merger transactions between 2009 and 2016 involving venture-backed targets (as reported in Dow Jones VentureSource) in which the merger documentation was publicly available and the deal value was $25 million or more. Based on this review, we have compiled the following deal data:

Characteristics of Deals Reviewed	2009	2010	2011	2012	2013	2014	2015	2016
Sample Size	15	17	51	26	27	37	27	19
Cash	60%	71%	73%	73%	59%	59%	67%	47%
Stock	0%	6%	4%	8%	8%	3%	4%	0%
Cash and Stock	40%	23%	23%	19%	33%	38%	29%	53%
Deals with Earnout	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
With Earnout	27%	29%	29%	31%	33%	30%	26%	37%
Without Earnout	73%	71%	71%	69%	67%	70%	74%	63%
Deals with Indemnification	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
With Indemnification								
By Target's Shareholders	100%	100%	98%	100%	100%	97%	100%	100%[1]
By Buyer	36%	17%	43%	62%	44%	49%	69%	37%
Survival of Representations and Warranties[2]	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Shortest	6 Mos.	9 Mos.	12 Mos.	10 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
Longest	18 Mos.	21 Mos.	24 Mos.	24 Mos.	30 Mos.	24 Mos.	24 Mos.	18 Mos.
Most Frequent	18 Mos.	18 Mos.	18 Mos.	18 Mos.	18 Mos.	12&18 Mos. (tie)	18 Mos.	18 Mos.
Caps on Indemnification Obligations	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
With Cap	100%	100%	100%	100%	100%	100%	100%	100%
Limited to Escrow	71%	71%	77%	81%	88%	89%	79%	83%
Limited to Purchase Price	0%	6%	2%	0%	0%	0%	0%	0%
Exceptions to Limits[3]	71%	94%	96%	96%	100%	100%	100%	95%
Without Cap	0%	0%	0%	0%	0%	0%	0%	0%
Escrows	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
With Escrow	93%	100%	94%	100%	93%[4]	97%	93%	89%
% of Deal Value								
Lowest[5]	10%	2%	5%	5%	5%	2%	4%	5%
Highest	15%	25%	31%	16%	20%	16%	16%	15%
Most Frequent	10%	10%	10%	10%	10%	10%	10%	10%
Length of Time								
Shortest	12 Mos.	9 Mos.	12 Mos.	10 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
Longest	18 Mos.	36 Mos.	36 Mos.	48 Mos.	30 Mos.	24 Mos.	36 Mos.	24 Mos.
Most Frequent	12&18 Mos. (tie)	18 Mos.	18 Mos.	12 Mos.	18 Mos.	12 Mos.	12&18 Mos. (tie)	18 Mos.
Exclusive Remedy	46%	53%	78%	73%	60%	86%	63%	88%
Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy	83%	80%	97%	100%	100%	100%	100%	93%
Baskets for Indemnification	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Deductible[6]	43%	56%	38%	27%	50%	44%	31%	47%
Threshold[6]	57%	44%	60%	65%	42%	56%	61%	53%
MAE Closing Condition	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Condition in Favor of Buyer	100%	100%	98%	95%	100%	97%	100%	100%
Condition in Favor of Target	20%	19%	15%	9%	17%	19%	12%	39%
Exceptions to MAE	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
With Exception[7]	93%	94%	94%[8]	84%[9]	96%[10]	100%	100%	100%

1 Includes one transaction where the only representations that survive for purposes of indemnification are certain "fundamental" representations and representations concerning material contracts and intellectual property.
2 Measured for representations and warranties generally; specified representations and warranties may survive longer. Excludes one transaction in each of 2011 and 2014 where general representations and warranties did not survive.
3 Generally, exceptions were for fraud, willful misrepresentation and certain "fundamental" representations commonly including capitalization, authority and validity. In a limited number of transactions, exceptions also included intellectual property representations.
4 One of two transactions not including an escrow at closing did require funding of escrow with proceeds of earnout payments.
5 Excludes transactions which also specifically referred to representation and warranty insurance as recourse for the buyer.
6 A "hybrid" approach with both a deductible and a threshold was used in another 2% of these transactions in 2011, 8% of these transactions in 2012, 8% of these transactions in 2013, and 8% of these transactions in 2015.
7 Generally, exceptions were for general economic and industry conditions.
8 Excludes one transaction where the specified exceptions do not apply for purposes of a standalone "material adverse effect" closing condition.
9 Includes one transaction where the specified exceptions apply for purposes of a standalone "material adverse effect" closing condition and certain representations, but do not apply for purposes of other representations.
10 The only transaction not including such exceptions provided for a closing on the same day the definitive agreement was signed.

Trends in Convertible Debt Terms

Based on more than 100 convertible debt financing transactions we handled from 2014 to 2016 for companies and investors throughout the United States, we have compiled the following deal data:

Deals with Note Purchase Agreement		**2014**	**2015**	**2016**
Convertible note investors often require the company to enter into a note purchase agreement containing representations and warranties from the company (and possibly the founders).	% of Deals	64%	74%	67%
Term		**2014**	**2015**	**2016**
The term of the convertible note before it becomes due and payable.	Median	18 mos.	18 mos.	18 mos.
	Range	1–72 mos.	4–60 mos.	2–60 mos.
Interest Rate		**2014**	**2015**	**2016**
The rate at which interest accrues during the term of the convertible note.	Median	6%	5%	5%
	Range	0.33%–15%	2%–14%	0.64%–10%
Deals with Security Interest		**2014**	**2015**	**2016**
Convertible note investors sometimes require the company to provide a security interest in some or all of the company's assets. If the note is not repaid or converted into capital stock, the pledged assets would become available to satisfy the note.	% Secured	20%	15%	13%
	% Unsecured	80%	85%	87%
Deals with Conversion Discount		**2014**	**2015**	**2016**
Convertible note investors often require that the notes convert in connection with a financing at a discount from the price paid by new investors in the financing to reward the convertible note investors for the risk of investing before the new investors. A conversion discount is often coupled with a cap on the valuation at which the notes convert.	% of Deals	72%	89%	72%
	Range of Discounts	10%–50%	10%–50%	10%–50%
	% with 20% or Less Discount	76%	74%	69%
	% with Greater Than 20% Discount	24%	26%	31%
	% with Valuation Cap	74%	55%	64%
Deals with Conversion upon Maturity		**2014**	**2015**	**2016**
If a convertible note is not converted or otherwise paid upon maturity, it often converts into shares of the company's capital stock (common or preferred stock). This conversion is most often at the election of the investor but may be mandatory.	% of Deals	57%	60%	50%
	% with Optional Conversion	90%	89%	89%
	% with Mandatory Conversion	10%	11%	11%
	% that Convert into:			
	Common	54%	32%	41%
	Preferred	46%	68%	59%
Deals with Conversion upon Company Sale		**2014**	**2015**	**2016**
If a convertible note is not converted or otherwise paid at the time of a sale of the company, it often converts into shares of the company's capital stock (common or preferred stock). This conversion is most often at the election of the investor but may be mandatory.	% of Deals	66%	74%	46%
	% with Optional Conversion	86%	91%	92%
	% with Mandatory Conversion	14%	9%	8%
	% that Convert into:			
	Common	60%	49%	56%
	Preferred	40%	51%	44%
Deals with Conversion Premium upon Company Sale		**2014**	**2015**	**2016**
Convertible note investors may require that they receive a multiple of the outstanding principal of the convertible note upon a sale of the company.	% of Deals	52%	53%	57%
	Median Premium	2x	2x	2x
	Range of Premiums	1.5x–3x	1.5x–4x	0.5x–3x
Deals with Warrant Coverage		**2014**	**2015**	**2016**
Convertible note investors sometimes receive a warrant in addition to a note. The amount of company stock covered by the warrant is usually proportional to the principal amount of the note, referred to as the warrant coverage. For example, if the investor is funding $100,000 and the warrant coverage is 10%, then the number of shares of stock for which the warrant is exercisable would equal $10,000 divided by the warrant exercise price.	% of Deals	11%	4%	17%
	Coverage Range	1%–50%	Insufficient data	5%-50%
	% that Cover Common	20%	50%	0%
	% that Cover Preferred	80%	50%	100%

Based on hundreds of venture capital financing transactions we handled from 2011 to 2016 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2011	2011 Range	2012	2012 Range	2013	2013 Range	2014	2014 Range	2015	2015 Range	2016	2016 Range
A "multiple liquidation preference" is a provision that provides that the holders of preferred stock are entitled to receive more than 1x their money back before the proceeds of the liquidation or sale are distributed to holders of common stock.	Series A	7%	1.2x–3x	0%	N/A	5%	2x–3x	0%	N/A	2%	1.5x (all)	0%	N/A
	Post–Series A	4%	1.3x–1.5x	7%	2x–2.4x	9%	1.5x–2.17x	3%	1.5x (all)	4%	1.5x–2x	4%	1.12x–1.25x

Deals with Participating Preferred Stock		2011	2011 Range	2012	2012 Range	2013	2013 Range	2014	2014 Range	2015	2015 Range	2016	2016 Range
"Participating preferred" stock entitles the holder not only to receive its stated liquidation preference, but also to receive a pro-rata share (assuming conversion of the preferred stock into common stock) of any remaining proceeds available for distribution to holders of common stock.	Series A												
	Total	24%		15%		8%		12%		6%		13%	
	Capped	45%	2x–3x	43%	2x–10x	50%	2x–3x	40%	3x–5x	100%	2x–3x	Insufficient data	
	Post–Series A												
	Total	34%		27%		24%		19%		19%		28%	
	Capped	30%	1.75x–8x	44%	2x–3x	41%	2x–5x	45%	2x–5x	50%	2x–5x	34%	2x–5x

Deals with an Accruing Dividend		2011	2012	2013	2014	2015	2016
"Accruing dividends" are generally payable upon liquidation or redemption of the preferred stock. Because the sale of the company is generally deemed to be a "liquidation," the accrued dividend effectively increases the liquidation preference of the preferred stock.	Series A	18%	29%	9%	11%	12%	23%
	Post–Series A	43%	28%	11%	22%	25%	30%

Anti-Dilution Provisions		2011	2012	2013	2014	2015	2016
A "full ratchet" anti-dilution formula is more favorable to the investors because it provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a "weighted average" anti-dilution formula takes into account the dilutive impact of the dilutive issuance based upon factors such as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	Series A						
	Full Ratchet	2%	0%	0%	0%	0%	0%
	Weighted Average	98%	100%	100%	100%	100%	100%
	Post–Series A						
	Full Ratchet	3%	3%	1%	1%	0%	1%
	Weighted Average	97%	97%	99%	99%	100%	99%

Deals with Pay-to-Play Provisions		2011	2012	2013	2014	2015	2016
"Pay-to-play" provisions provide an incentive to investors to invest in future down rounds of financing. Investors that do not purchase their full pro-rata share in a future down round lose certain rights (e.g., their anti-dilution rights are taken away or their shares of preferred stock may be converted into common stock).	Total	19%	7%	7%	8%	5%	10%
	% of Total that Convert into Common Stock	82%	100%	100%	53%	71%	94%
	% of Total that Convert into Shadow Preferred Stock	18%	0%	0%	47%	29%	6%

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Data Sources: WilmerHale compiled all data in this report from Dow Jones VentureSource, except as otherwise indicated. For law firm rankings, IPOs by VC-backed companies and sales of VC-backed companies are included under the current name of each law firm.

Special note on data: Due to delayed reporting of some transactions, the venture capital financing and M&A data discussed in this report is likely to be adjusted upward over time as additional deals are reported. Based on historical experience, the adjustments in US data are likely to be in the range of 5–10% in the first year following the initial release of data and in smaller amounts in succeeding years, and the adjustments in European data are likely to be more pronounced.

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