WILMER, CUTLER & PICKERING

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Investing In An ECommerce Start-Up

New start-up companies are sprouting every day. Here are guidelines and checklists to keep in mind when investing in start-up companies.

Who is an investor? When do investors invest? Investors usually fall into one of three categories. First, there is the "angel" investor — named after the theater lover who puts up his or her own money to keep a play or musical running — who usually invests modest amounts of money. An angel will often provide the "seed money" (anywhere from $25,000 to $1 million) to help a company get up and running. An angel usually does not immerse himself or herself in the control or management of the company.

Second, on the other end of the spectrum, there are venture capitalists, or VCs. VCs are partners or employees of investment funds that are formed with cash from institutional investors and wealthy individuals. VCs usually invest in start-up companies with fairly well-developed business plans. They are searching for companies that are looking for a significant round of financing. The first significant round of financing is often referred to as the "A round" (because Series A Preferred Stock typically is issued). The second round is referred to as the "B round" (because Series B Preferred Stock typically is issued). A later-stage investment made in a company to help it move to an IPO is called a "mezzanine round" because it is between the earlier private equity rounds and the public offering.

Third, there are the established companies, which are usually looking to invest in a start-up for two reasons: (i) a strategic motivation, such as obtaining a license to the start-up's key technology; and/or (ii) financial returns, with a targeted high rate of return. Many large public companies are now forming their own VC funds to make these kinds of investments. Other public companies are entering into "strategic alliances" with companies in which they form their own start-up company to enter into a new, but related, line of business.

What do investors receive in return for their investments? There are a variety of ways to invest in a start-up company. An investor may receive any number of debt or equity securities, or a combination of them, in return for the investment.

Equity. The investor — particularly an angel investor — may receive common stock of the corporation, giving the investor all of the rights of a stockholder under the applicable jurisdiction's corporate laws and allowing the investor to participate in the control of the company by designating and voting for directors of the company.

In the alternative, an investor — particularly a VC or company investor — may receive preferred stock, with specified rights and preferences that are negotiated between the company and the investor. Preferred stock also may be converted into common stock at the choice of the investor or on the occurrence of certain events, such as an initial public offering. The category and amount of stock owned by the investor will normally determine the level of control the investor has over the company. The usual security for a VC investment is preferred stock (with a dividend and liquidation preference) that converts into common stock. VCs also usually negotiate a seat on the company's board of directors, various exit mechanisms, and veto rights over major corporate actions, such as issuing new stock, selling or liquidating the company, or amending the articles of incorporation. (We are assuming that the start-up is a standard "C" corporation. Although similar investments can be made in a limited liability company or "S" corporation, there will be additional complexities, such as the fact that an "S" corporation can only issue one class of stock.)

Debt. Instead of receiving an equity ownership in the company, the investor may prefer to receive a note or a debenture in return for their investment. The advantage to receiving debt as opposed to equity in a company is that the investor has priority as a creditor in the event of bankruptcy or insolvency. Although these debentures are usually subordinate to any bank loans the company may have, some or all of the companies' assets can secure them as collateral. The disadvantage to receiving debt is that the investor typically has less control over the company. This can be addressed, however, by including covenants that require the creditor's consent before the company can take certain actions, such as borrowing more money or selling its assets.

Debt/Equity Combination. The investor may choose a combination of debt and equity in the form of a convertible debenture. This instrument has many advantages. It starts out as debt and

thus has liquidation priority over all equity securities. Because it is convertible into equity, however, it also has benefits on the upside if the company does well. Key questions are: (i) when does the debt convert into equity? (ii) is the conversion optional at the election of the investor or mandatory on the occurrence of certain events? (iii) can the company redeem the debt? and (iv) what covenants does the investor have? Another way to accomplish this structure (which comes with different tax ramifications) is for the investor to receive a non-convertible debt instrument (such as a promissory note) and warrants.

How does an investor get information about a start-up? After initial meetings with the management of the start-up, an investor should consult with legal advisors. It is at this point that the investor will begin entering into agreements with the company that will greatly affect the form and outcome of his or her investment.

Due Diligence. The investor should ask his or her legal advisors to conduct a due diligence review of the company. This should prompt preparation of a list sent by the legal advisor to the company requesting production of its corporate books and records, financial statements, copies of any and all agreements or contracts it has entered into, employee benefit or stock option plans, patents or trademark registrations, property titles or leases, and evidence of any legal proceedings. The due diligence team will review these documents and report back to the investor on its findings.

Many factors will determine the level of due diligence required, including the size of the investment, the size and maturity of the company, when the last due diligence review was done, the investor's risk tolerance, and the importance of quickly funding the investment. Many Internet start-up companies have few assets other than intellectual property rights — which shortens the due diligence process considerably. In other start-up companies, such as those in the business of providing communications infrastructure, there may be many assets and liabilities (and the due diligence process will be time-intensive). Another factor that determines the scope of due diligence necessary is whether or not the company has allowed other investors to conduct due diligence. If a previous investor has recently conducted due diligence, it may be possible to rely on the prior investigation and simply update it with any new material information.

Non-Disclosure/Confidentiality Agreements. While conducting due diligence, the investor will have access to highly confidential information about the company. To protect itself, the company will usually ask the investor to enter into a confidentiality or non-disclosure agreement. This agreement prohibits the investor from disclosing any of the confidential information it obtains from conducting its due diligence to third parties. While this kind of agreement is common, it is important that it be reviewed by legal counsel prior to execution to ensure that it will not hamper the investor from conducting due diligence on other competing companies or otherwise overly restrict the investor.

Term Sheet. The investor and company will probably develop a term sheet outlining the details of the investment. (In some deals no term sheet is used.) The term sheet may be entered into before or after due diligence is conducted, with the understanding that the terms of the investment are subject to change on completion of the due diligence investigation. While usually not binding, the term sheet may be heavily negotiated between the parties. Investors and companies may agree to make certain portions of the term sheet binding, such as provisions dealing with expenses. Investors should involve experienced counsel in the term sheet process because most of the key issues will be discussed and resolved at this point (including various exit mechanisms, transfer restrictions, veto rights, and anti-dilution mechanisms).

What agreements will an investor need to enter into? There are numerous documents that the investor and/or the company may enter into. Here is a list of documents for a typical equity investment:

- *Securities Purchase (Subscription) Agreement*. This agreement is between the company, as the issuer of the securities, and the investors. The agreement contains the mechanics of the investment (including conditions to closing) and representations and warranties by both the company and the investors. This agreement also may contain covenants such as put/call options.
- *Investors' Rights Agreement.* This agreement sets out the rights granted by the company to the investors who are parties to the agreement. Such rights usually include (i) the right to have securities registered with the SEC for resale (referred to as "registration rights"); (ii) the right to participate in any future issuance of the company's securities (referred to as either a "right of first offer" or "preemptive rights"); and (iii) the right to receive the company's financial statements, budgets, and other information (referred to as "information rights"). These provisions often are included in the Stockholders Agreement and/or Registration Rights Agreement if there is not an Investors' Rights Agreement.
- *Co-Sale/Right of First Refusal Agreement.* This agreement sets out various rights of the investors to transfer stock, including restrictions imposed on company "insiders." These transfer restrictions and exit mechanisms typically include (i) the requirement that insiders first offer their securities to the company and the investors before selling to a third party (referred to as a "right of first refusal"); (ii) the requirement that if the investors do not exercise their right of first refusal, the investors can sell a percentage of their securities along with the selling stockholder to a third party (referred to as "co-sale" or "tag-along" rights); and (iii) the requirement that if a fixed percentage of the securities held by the investors vote to sell the company, all other parties to the agreement also must sell their securities on the same terms to the third party (referred to as a "drag-along" right). These provisions often are included in the Stockholders Agreement.
- *Voting Agreement*. This agreement is among stockholders (and often the company as well) to ensure that certain stockholders have the right to designate and remove a set number of directors from the company's board of directors. These provisions also often are included in the Stockholders Agreement.
- *Amended Certificate of Incorporation.* The company's certificate of incorporation usually is amended to include the rights and preferences of the equity

securities issued to the investor. In the case of convertible preferred stock, this agreement also contains anti-dilution provisions that adjust the number of shares of common stock into which the preferred stock converts to account for stock splits and other changes to the capital structure of the company. Most VCs will ask for "economic anti-dilution," which adjusts the number of shares into which the preferred stock converts if the company has a "down round," meaning that the price per share is less than the price paid in an earlier round. The formula for determining the adjustment is typically a "weighted average" formula that takes into account both the price of the cheaper stock and the number of shares issued. A more draconian formula known as the "full ratchet" adjusts the conversion to the same price as the new stock regardless of the number of shares issued. This document also contains voting rights, such as separate class voting for directors and approval of certain corporate actions. The amended certificate of incorporation is a public document that should be filed before the investor funds his or her investment.

What should I think about when investing in a start-up?

Valuation. Determining the valuation of a start-up is extremely tricky. Some key considerations include: (i) how long will the investment be in the company; (ii) what the valuation of the company likely will be when the investor takes its money out of the company; (iii) does the company own key intellectual property; (iv) what are the strengths and weaknesses of the management team; (v) what is the potential market and scalability (its ability to perform as it expands its business); and (vi) what is its projected cash flow. "Pre-money valuation" refers to the company's valuation prior to the investment, and "post-money valuation" refers to the company's valuation after the investment.

Investment Strategy. What is the purpose of the investment? Key questions are: is the investment purely for the upside if the company succeeds or is there a strategic purpose for the investment, such as possibly acquiring the company or obtaining a license to key technology? Other considerations are: has the company received any prior investments? how many more rounds of investment are likely needed before the company goes public or is sold?

Exit Strategy. How, and when, will the investor obtain liquidity? Two primary ways to exit an investment occur when (i) the company goes public, or (ii) the company is sold. If the investment is debt — or equity with a redemption feature — investors can require that the investment be returned at a certain time in the future regardless of whether another liquidity event has occurred (assuming the company has the funds at that time to be able to honor this commitment).

Control. How much of the company will you own and what control rights will you have after the investment? The amount of your investment likely will determine the control mechanisms you are able to obtain. Control of the company may come in the form of supermajority voting requirements ("veto rights") at the board of directors and/or shareholders level in the case of an equity investment and affirmative and/or negative covenants in the case of a debt investment.

Workable Business Plan/Financial Model. Is the business plan focused and well-organized? Does the company have a novel business idea or the potential to be the leader in a specific aspect of the industry? Has the company generated any profits or revenues? Is the projected financial model realistic?

Due diligence. How much due diligence will be required prior to an investment in the company? Has due diligence already been conducted by a prior investor?

Strong Management Team. Does the management team have experience in the industry? Does the team work well together? Have the key members of the management team entered into non-competition or employment agreements with "golden handcuffs" (incentives that keep key managers motivated and employed by the company)?

Corporate Ownership. Who owns the company? Are founders and key employees properly incentivized to tie them to the company (*e.g.*, through vesting schedules)? What is the option pool? Who are the other investors and are separate classes of votes required? If so, are you comfortable with your co-investors and the percentage of securities you will own?

Intellectual Property. Does the company own or control substantial intellectual property rights? Has the company taken the appropriate steps necessary to protect those rights? Is there a risk of infringement?

Our ECommerce, Business Transactions, and Latin America Practice Groups represent a number of angels, start-ups, venture capital funds, and strategic investors in the U.S., Europe, and Latin America. Please call us if you have any questions about these issues.

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MONTHLY UPDATE

106TH CONGRESS

The target adjournment date for the 106th Congress is October 6. As of the date of this publication, only two of the thirteen annual appropriations bills have been forwarded to the President for his signature. Many pieces of ecommerce legislation will be put off until next year, and will have to face the scrutiny of a different Congress and different Administration.

ELECTRONIC SIGNATURES. The recently enacted Electronic Signatures in Global and National Commerce Act becomes effective October 1. Under the new law, a commercial transaction cannot be denied legal

effect or enforceability solely because it was conducted electronically. The provisions of the law concerning electronic record keeping become effective March 1, 2001.

See the August 2000 edition of Wilmer, Cutler and Pickering's ECommerce News for detailed analysis of the legislation.

Workforce Development: H1-B. The Senate is poised to approve legislation (S. 2045 Sen. Hatch, R-UT) to increase the cap on the number of work visas, known as H1-B visas, that allow U.S. companies to fill jobs with highly-skilled foreign workers. The bill would raise the number of visas issued to 195,000 in each of fiscal years 2001 to 2003. The bill had long been stalled amid partisan squabbling over unrelated immigration amendments. House leaders have been waiting for Senate action before advancing either the industry-backed H.R. 3983 which raises the cap to 200,000 over three years or H.R. 4227 which removes the cap for three years while imposing onerous regulatory burdens on applicants. With an estimated 300,000 high-technology jobs going unfilled, the technology industry has been advocating another increase. The cap was reached for fiscal year 2000 in March. Harris Miller, President of the Information Technology Association of America has likened the labor shortage to running out of iron ore in the middle of the Industrial Revolution.

International Trade: China. After two weeks of intense debate, on September 19 the Senate passed HR 4444 to permanently extend normal trade relations status to the People's Republic of China. The measure has been cleared for the President who has indicated he will sign it. The legislation paves the way for China's entry into the World Trade Organization.

Privacy. The House is slated to consider H.R. 4049, a bill to establish the Commission for the Comprehensive Study of Privacy Protection. This bipartisan legislation would create a commission to study and make recommendations to Congress on financial, on-line, and health privacy. The seventeen-member panel would hold a series of hearings throughout the country regarding Internet privacy, identity theft, and protections for health, medical and financial records. Supporters of the "commission" approach contend it is the only privacy initiative that can be enacted this year, a view shared by House Majority Leader, Rep. Dick Armey (R-TX). Some Democrats are expected to harshly criticize the commission initiative when it comes to the floor.

Meanwhile, Sen. John McCain (R-AZ) announced his intention to hold hearings October 3 on S. 2928, a comprehensive privacy protection bill he is sponsoring with Sen. John Kerry (D-MA).

Spam. While the House passed anti-spamming legislation in July by a vote of 427 to 1, the Senate version has remained stalled. However, there has been movement of late to try to reach a compromise. The House bill requires unsolicited commercial email to include a header identifying the message as an advertisement and to include a valid return email address.

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