Hale and Dorr

Spring 2003
Issue Number Three

FULL RATCHET

THE TRANS-ATLANTIC VENTURE CAPITAL REVIEW

Rough Justice or Fair Cop?

The Reality of Anti-dilution Provisions

By Struan Penwarden

"We need protection against dilution if you engage in future down rounds," said venture capitalists three years ago, not really believing that they would need to call upon this protection. However, the unexpected and significant decline in valuations for companies over recent years has focused the attention of VCs and VC-backed companies on anti-dilution provisions. In today's investment climate, VCs are not only more selective with their potential investments, but are also demanding more favourable financial and control provisions in term sheets. In particular, protection against downside risk is of much more significant importance.

Companies seeking capital may accept VC requirements for anti-dilution protection without understanding the full implications of what they are giving. VCs often refer to "standard" anti-dilution provision as if an agreed standard exists. Although there are some general models, anti-dilution provisions are highly negotiable and therefore require an understanding of the components of the protection afforded to both parties.

Protecting Downside Risk

Anti-dilution provisions serve one fundamental purpose: they protect existing VCs from the adverse impact experienced when a company issues new securities (which can include preference shares, ordinary shares and/or options) at a lower price than that paid by the existing VCs. Anti-dilution protection comes in two principal varieties: *full ratchet* and *weighted average* formulas. In each case, the anti-dilution protection is implemented either by an adjustment to the conversion ratio of the VCs' preference shares into ordinary shares or by the issue of additional shares to the VCs.

Full ratchet formulas are the most aggressive form of anti-dilution provision and provide the most protection to VCs but have the greatest negative impact on companies. The mechanics of a full ratchet provision are quite simple, in that the VC will be entitled to be placed in the position (i.e. by reference to the number of preference shares held or number of ordinary shares into which the preference shares will convert) it would have been in had it originally invested in the company at the lower price per share being offered on a subsequent issue.

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To entrepreneurs, the full ratchet formula may appear inequitable because it fails to take into account the number of new shares actually issued by the company in a down round or other shares issued at a price less than that paid by the existing VC. Weighted average formulas, on the other hand, by taking into account the number of shares (sometimes including other convertible securities, such as options) already in issue plus the number of new shares being issued at the lower price, can be viewed as more equitable. These types of formulae have the effect of determining the adjustment to be made to an existing VC's shareholding based on an average of the price the VC paid for its shares and the lower price at which the new shares are to be issued. There are different variations of the weighted average formula, but these may be essentially categorised as either *broad*- or *narrow-based*. Broad-based weighted average includes a wider range of shares and other securities in the calculation and therefore the adjustment required to the VC's shareholding is less. Therefore, it is less onerous on the company and not as dilutive on the shareholdings of management and the founders.

Full ratchet formulas are the most aggressive form of anti-dilution protection and have the greatest negative impact on companies.

Pre-Emption Protection v. Anti-dilution Protection

Anti-dilution provisions are commonly confused with *pre-emptive rights*. A pre-emptive right (either a *right of first offer* or a *right of first refusal*) enables an existing investor to purchase a proportion of any subsequent issue or sale of securities so as to ultimately retain or increase their percentage shareholding in the company. A pre-emptive right will be triggered regardless of whether the subsequent issue is for greater or less than the amount paid by the existing VC for their shares. Anti-dilution provisions protect a VC without requiring the VC to pay more (although see *pay-to-play* provisions discussed below), whereas a pre-emptive right requires the existing VC to purchase additional shares to get the benefit of its protection. Accordingly, the VC may receive more protection from a pre-emptive right because it ensures the VC maintains a specific percentage ownership following each issue of shares. However, this benefit is mitigated by the fact that the VC must invest additional money in the company.

Full Ratchet or Weighted Average?

The negotiation of which anti-dilution formula to use can be contentious. A fall in a company's valuation may be caused by a combination of many factors and not just a fall in the general market. For example, the company may have not reached certain performance milestones that were set on the last funding round and now has to revise its business plan. When negotiating anti-dilution protection, VCs may take the view that they are investing at the agreed price per share on the basis that the business plan (and any milestones therein) will be realised and result in an increased valuation of the company (and of their investment). Accordingly, the VC will want to be protected against any downside in the event that this does not occur. To a VC, a full ratchet adjustment is often seen as the appropriate protection in that the dilutive nature of a fundraising at a lower valuation should be borne by the founders and the management team effecting the business plan and not the VC.

However, from an entrepreneur's perspective, this may seem unfair. The VCs will have been shareholders of the company during the period of decline in valuation and are also likely to have been represented on the board of directors. VCs not only bring money to their portfolio companies but also can add value through their experience and industry expertise. Accordingly, entrepreneurs may feel that the impact of a drop in valuation in the company should be shared among the VCs, management and founders, and therefore a weighted average anti-dilution adjustment is more appropriate.

Full Ratchet Anti-dilution in Practice

There are a number of European VCs who insist on full ratchet anti-dilution as a matter of course. However, to date, a number of these VCs have not fully invoked this protection - even in a down round - because it would have disastrous effect on the company and its management team. Some VC-backed companies that had agreed to full ratchet anti-dilution protection on their last funding round are finding that, due to the tremendous decline in their valuations, the effect is that VCs may be entitled to millions of additional shares, essentially wiping out the ownership stake of the founders and management. Clearly, this not only disincentivises management but also any potential new investors. In such a scenario, the reality is that the VC-backed company, existing VCs and new investors must come to an arrangement if a further fundraising is to be concluded. This may involve the existing VCs waiving part or all of their anti-dilution adjustment and/or agreeing to an increased option pool for management (to compensate management for significant dilution). From the perspective of the VC with full ratchet anti-dilution protection, such protection may be used primarily as a bargaining "chip" in the negotiations for subsequent financings in which they are not leading the financing.

Minimising the Impact of Full Ratchet Protection

Since the fall in valuations and the slowdown of the IPO and M&A markets, VCs are in a stronger bargaining position and are returning to stricter investment criteria. However, some VCs are realising that harsh terms may act to misalign management and investors' interests and hamper a company in attracting future financing.

If a company has any leverage, it can reduce the impact of anti-dilution protection by basing it on a weighted average formula that is as broad-based as possible. If full-ratchet anti-dilution protection is unavoidable, then one should attempt to limit its effect. The following are popular methods of reducing the effect of a full ratchet provision (and in some cases, a weighted average provision):

- negotiating a time limit after which the VCs' full ratchet anti-dilution protection switches to a weighted average formula or ceases altogether;
- negotiating a share price floor, whereby if price per share in the down round is below a specific price the VC would only be entitled to a weighted average anti-dilution protection;
- negotiating a shareholding percentage cap, whereby any increase in percentage ownership of the company is capped at an agreed level;
- negotiating performance adjustments, which allow the founders and/or management team to recoup the reduction in their share ownership percentage caused by a down round anti-dilution adjustment once the company has met predetermined milestones; and/or
- negotiating pay-to-play provisions, which require investors who have anti-dilution protection to exercise their pre-emption rights to invest their pro rata share in subsequent rounds of financing or otherwise lose this protection. In other words, VCs are required to demonstrate their commitment to the company before receiving the benefit of anti-dilution protection.

While the balance of power will likely be in the favour of VCs for quite some time to come, there are things an investee company can do to minimise the affects of anti-dilution protection in a down round.

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Full ratchet anti-dilution may be used by a VC as a bargaining "chip" in negotiations for subsequent financings.

Isar Valley Update

Trouble in the Tranches

by Dr. Johannes Maidl

In venture capital transactions, it is a common practice to structure an investment by way of *milestones* or *tranches* whereby, after an initial investment, any further investment is made by the VC only upon the successful satisfaction by the company of a specific or defined milestone. In fact, many VCs consider milestones to be an effective way for an investor to manage the risk of investing. In Germany, however, VC investors may need to reconsider this structure in light of a recent court decision.

Typically, in German VC transactions with a milestone investment structure, the investment agreement provides that the VC will pay at the time of the first closing. Due to the issues related to increasing share capital in German companies, at the time of the first closing the VC is issued all of the shares they are entitled to receive in all of the tranches (as if all of the milestones have already been achieved). To ensure that the VC only has the rights attaching to the fully paid shares, contractual provisions are often implemented with respect to the shares that remain subject to the satisfaction of the milestones. If and when the company achieves the specified milestones, the VC is then contractually obliged to pay an additional agreed amount (equal to the original purchase price, less the nominal value per share that has already been paid). In practice, these additional payments have been characterised as "payments into the free capital reserves" (*Zuzahlung in die freie Rücklage*) and not as "share premium" (*Agio*). However, amongst lawyers handling VC investments, there has always been a question regarding whether a milestone payment was in fact a payment of share premium rather than a payment into free capital reserves. The validity of the issuance of the shares by the company to the VC depends upon this characterisation because, under the German Stock Corporation Act, any share premium has to be paid into the company's bank account *before* the shares are actually issued.

> VC investors in Germany may need to reconsider milestone investments in light of a recent court decision.

A recent German court decision has asserted that a milestone payment under an investment agreement is in fact a payment of share premium rather than a payment into free capital reserves. This suggests that, under the typical structure, the initial issuance of shares for which only the nominal value has been paid is null and void, as the share premium was not paid prior to the issuance of the shares. Although the court was not directly faced with the issue, the court also noted in an aside that, if the obligation to make the milestone payments was set forth in a shareholders' agreement to which the company was not a party, then the payments might be viewed as payments into the free capital reserves rather than share premium. Assuming that the court's latter view is correct and accepted by other courts, it is nevertheless a very undesirable result for VC-backed companies. If the company is a party to the shareholders' agreement, then the milestone payment would be deemed to be share premium (and the issuance of shares would be null and void). If the company is not a party to the shareholders' agreement, then the milestone payment would be deemed to be a payment into the free capital reserves (and the issuance of shares would be valid), but because the company is not a party to a shareholders' agreement, the company cannot legally force a recalcitrant investor to make the milestone payment that has become due. The company would have to rely on the other shareholders who are parties to the shareholders' agreement to enforce the milestone payments for the benefit of the company. Because under the law the validity of using a shareholders' agreement to make the milestone payments is far from certain, even without the company as a party, VCs will also run a significant risk if they were to rely on this structure.

This recent court decision does not necessarily mean the end of structuring venture capital investments in German companies by way of milestones. One potential alternative method to achieve a similar result would be the use of convertible bonds as an appropriate substitute. A convertible bond could be issued at a nominal value and provide for an additional payment in the event of conversion. Upon the achievement of the milestone, the additional payment would be required for the bond to convert. However, because a convertible bondholder does not have voting rights, voting arrangements between the VC and the other shareholders would have to be provided by means of a voting agreement.

We expect to see significant modifications in the structure of typical German VC transactions in the coming months as parties adjust to this new development.

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U.S. Update

Impact of U.S. Corporate Governance Reforms on VC-backed Companies

By Pat Rondeau and David Westenberg

Public U.S. companies are facing dramatic changes in disclosure and corporate governance requirements under the Sarbanes-Oxley Act of 2002 and new or proposed rules from the Securities and Exchange Commission (SEC), NASDAQ and the New York Stock Exchange (NYSE). While these new rules and regulations do not generally cover private companies, certain aspects of the Sarbanes-Oxley Act may indirectly become applicable to a private company if it is acquired by a public U.S. company. In addition, the boards of directors of many private U.S. companies are embracing various aspects of the Sarbanes-Oxley Act as "best practices."

Summarised below are the new requirements that are most likely to be relevant to private companies. Familiarity with these new rules will help private companies avoid pitfalls that could interfere with important future milestones, such as an IPO in the U.S. or an acquisition by a public U.S. company.

Prohibition on Personal Loans

The Sarbanes-Oxley Act prohibits public U.S. companies from extending, maintaining, renewing or arranging personal loans to directors or executive officers. Private companies should consider prohibiting all officer and director loans or requiring repayment before the company undertakes an IPO or is acquired by a public U.S. company if the borrower is, or will become, a director or executive officer of the public U.S. company. However, private companies should bear in mind that repayment prior to an IPO in the U.S., or an acquisition by a public U.S. company, may not be practical since there will not yet be a public market for the company's shares, and forgiveness of such loans may result in unfavourable accounting treatment.

Shareholder Approval for Option Plans

The NYSE has proposed changing its rules so that brokers holding shares of a public U.S. company in "street name" may vote those shares in favour of proposals to adopt a new employee share option plan or to increase the number of shares covered by an existing plan only if explicit voting instructions are received from the underlying beneficial owner. This change would affect all public U.S. companies, since it would apply to voting by all brokers that are members of the NYSE, regardless of where the shares being voted are listed in the U.S. This rule change may make it significantly more difficult for public U.S. companies to obtain shareholder approval of option plans. This underscores the need for a company contemplating an IPO in the U.S. to evaluate whether it needs to increase the number of shares covered by its employee share option plan and whether it wishes to adopt any new option plans – such as a director share option plan or an employee share purchase plan – while it is still a private company and shareholder approval is easier to obtain.

Board of Directors and Board Committees

Private companies should be prepared to comply with the new rules relating to the composition of a board of directors and board committees prior to an IPO in the U.S.:

- *Board Independence.* Proposed NASDAQ and NYSE rules require that a majority of the directors be "independent," although the proposed definition of "independent" varies between the two exchanges.
- *Audit Committees.* The Sarbanes-Oxley Act and proposed stock exchange rules impose heightened requirements for audit committee composition and impose additional responsibilities on the committee:
  - *Independence.* All members of the audit committee must be "independent," although there are certain limited exemptions for non-U.S. companies. In addition, if the company does not have an audit committee, then the entire board is considered the committee for these purposes. Of note is a proposed NASDAQ rule that would prevent 20% shareholders from being considered independent, which may disqualify some of a company's VC directors from serving on the audit committee. A proposed SEC rule would provide that persons owning less than 10% of a company's shares would not be precluded from being considered independent for audit committee purposes by virtue of their share ownership.
  - *Financial Expertise.* The Sarbanes-Oxley Act requires companies to disclose in their annual reports whether the audit committee has at least one "audit committee financial expert." The SEC's definition requires that the person have specified accounting expertise that is generally acquired either through experience as an accountant or as CFO or controller or through experience supervising such a person.

Familiarity with the new rules will help private companies avoid pitfalls that could interfere with an IPO in the U.S. or an acquisition by a U.S. company.

Any private company planning to go public in the U.S. should establish appropriate controls and procedures well in advance of its IPO.

- *Responsibilities.* The audit committee has the direct and sole responsibility for the appointment, compensation and oversight of the company's auditors. The audit committee is also responsible for pre-approving audit services and any permitted non-audit services.
- *Accounting Complaints.* The Sarbanes-Oxley Act requires the audit committee to adopt and implement procedures for receiving and handling complaints regarding accounting matters, including the confidential and anonymous submission of employee concerns regarding accounting matters.

- *Compensation Committees.* Both NASDAQ and the NYSE have proposed that compensation committees must consist solely of independent directors.
- *Nominating Committees.* NASDAQ has proposed that all director nominations be approved by a nominating committee consisting of independent directors or a majority of all independent directors. The NYSE has proposed that each listed company must have a nominating and corporate governance committee consisting solely of independent directors.

Relationship with Auditors

The Sarbanes-Oxley Act will affect a private company's relationship with its accountants:

- *Prohibition of Non-Audit Services.* The accounting firm responsible for performing a public U.S. company's audit is prohibited from performing specified non-audit services, although tax services generally are still permitted. Private companies receiving prohibited non-audit services from their auditors should be prepared to obtain these services from other parties upon an IPO in the U.S.
- *Rotation.* The lead audit partner and the concurring audit partner must be rotated at least every five years, and certain other partners involved in the audit must be rotated every seven years. Thus a private company beginning the IPO process with an audit partner it has had for four or more years may see that partner rotate off the company's account during or shortly after the IPO process. There are special transition rules for partners in non-U.S. accounting firms, which have the effect of deferring the rotation requirement for those partners.
- *Hiring Restrictions.* An audit firm is not independent if a company's CEO, CFO, chief accounting officer or controller (or another person in a "financial reporting oversight role") is a former employee of the audit firm who worked on the company's audit during the past year. Therefore, a private company should be careful hiring from its accounting firm during the year before it intends an IPO in the U.S.
- *Year-End Audit Crunch.* VC-backed private companies are typically required to provide investors with audited financial statements within 90 days after the end of the fiscal year. Recently adopted SEC rules that require public U.S. companies to file their annual reports sooner following fiscal year end, combined with the increased disclosure requirements for public U.S. companies, will likely make it more difficult and costly for private companies to get their audits completed within the required time frame. Private companies concerned about this "audit crunch" could change their fiscal year ends so that annual audits are performed later in the calendar year.

Disclosure Controls and Internal Controls

Public U.S. companies are now required to maintain, and periodically evaluate and report on the effectiveness of, "disclosure controls and procedures" – that is, controls and other procedures designed to ensure that information required to be disclosed by the company in its SEC reports is assimilated and processed within the required time periods. The SEC has proposed similar rules regarding "internal controls and procedures for financial reporting" – that is, controls regarding the preparation of financial statements for external purposes that are fairly presented in conformity with relevant GAAP.

Any private company planning to go public in the U.S. should establish appropriate controls and procedures so that it will not need to substantially re-engineer its business processes following an IPO. The IPO underwriters will scrutinise the company's controls and procedures as part of their due diligence process. Similarly, any potential public U.S. company acquirer will conduct significant due diligence on the private company's controls and procedures so that the acquirer is in a position to provide all required SEC certifications following the acquisition.

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Nuggets

Vesting Tax Woes of Founders' Shares

Tying the founders to the business is often an essential element of any VC investment. A typical method of doing this is to ensure that their shares are subject to vesting restrictions so that if they leave the company, then those shares, or at least some of them, are forfeited in some way. However, if potential tax traps are to be avoided, considerable thought should be given as to how the vesting is achieved. Rectifying any mistake made at the outset will either be impossible or, at least, expensive and time consuming.

For U.K. taxpayers (whether or not employed by a U.K. company), a poorly drafted arrangement can result in income tax charges *each time* shares vest. It is irrelevant that there is no market for the shares - income tax is calculated on the difference between the price the founder paid for those shares and the market value (as determined by the Inland Revenue) of those shares at vesting. A similar tax may arise for U.S. shareholders who receive their restricted shares in connection with the performance of services: potential U.S. income tax charges would be calculated in a similar way to those in the U.K.

Usually, founders will not want to pay tax on any vesting date since there is a danger (where there is no immediate market) that the shares subsequently decrease in value and tax is paid without receiving any benefit. Fortunately, tax charges on vesting can be avoided with careful planning. For example, for U.K. taxpayers, a company's charter documents can be drafted so that the commercial requirements are met but the restrictions on the shares fall outside of the legislation. The U.K. Inland Revenue have recently broadened their practice so that non-U.K. companies can also adopt this approach.

For U.S. taxpayers, a "section 83(b) election" may be appropriate. Such an election results in recognising income at the time the shares are acquired. If the individual paid the fair market value for those shares, then no tax charge should arise at that point. There are strict time limits for making such an election which, if they are not met, will result in this potentially very beneficial tax treatment being lost.

These types of issues should be checked in relation to any jurisdiction in which a founder is resident. It is common to impose income tax in similar ways in many other jurisdictions (such as Germany).

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Securing the Key Employees

It is essential that VC investors do all that is reasonably practicable to secure the services of key employees during the vital growth stages of a business. In addition to incentivising key employees through share options in the company, VCs should ensure that each key employee enters into a service agreement or contract of employment that includes the following:

- *Notice periods* help to secure the services of the key employee during a specific period of time following the employee or the company giving notice. Clearly, a balance must be achieved between severance costs that are likely to be higher if the notice period is longer, and the ability to hold onto the employee that is enhanced if the notice period is longer.
- *Garden leave clauses* will give the company the option to suspend the key employee from his or her duties and keep them from joining a competing business during the notice period.
- *Confidentiality clauses* prohibit an employee from disclosing or using any confidential information or trade secrets of the company. To be enforceable, this clause should clearly define what is meant by confidential information, which should include confidential business plans, product specifications, designs and customer lists. However, this clause should include carve outs for information which enters the public domain, is ordered to be disclosed by a court or, in some jurisdictions such as the U.K., is the subject of a protected act (such as whistle blowing).
- *Restrictive covenants* prevent the key employee from being involved in a competing business or from soliciting customers or other key employees of the business *after* the termination of employment. In certain jurisdictions, such as the U.K., restrictive covenants are enforceable if they only go as far as is reasonably necessary to protect the legitimate business interests of the company. In some European jurisdictions, however, non-compete clauses are only enforceable if there is monetary consideration in return for the covenant. Generally, restrictive covenants in contracts of employment are not as robust as those included in an investment agreement. Therefore, longer and wider covenants aimed at protecting a VC investment should be included in the investment documentation. The critical areas to consider for a non-competition clause are (1) the *subject matter* should be limited to the specific business of the company or that part with which the key employee was involved; (2) the *geographical scope* should be limited to the area in which the company operates; and (3) the *duration* or period of the restriction should be limited to that which is reasonably necessary to prevent the key employee from having an unfair advantage as a result of his employment by the company.

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The Essentials

The Full Ratchet Guide to Liquidation Preferences

A liquidation preference gives the VC investor a "first right" to any proceeds available to shareholders in the event of a liquidation or trade sale of the company. Although a liquidation preference provides the VC investor with downside protection by giving them the first money out of the company that is paid to shareholders, it can also significantly increase the upside to an investment.

A *non-participating liquidation preference* means the preferred shareholders can get their investment back upon a trade sale or liquidation of the company, with the balance of the proceeds going to the holders of ordinary shares. If the ordinary shareholders would get more per share than the preferred shareholders under this approach, the preferred shareholders can voluntarily convert their preference shares into ordinary shares and share pro rata in the proceeds.

Most VC investments include a *participating liquidation preference* that permits the VC to receive their money back first in a trade sale or liquidation of the company, with the balance of the proceeds being divided amongst the holders of ordinary shares and preferred shares on a share-for-share basis. The participating preference is often referred to as a "double dip" because the VC investor receives their money back and then gets a share of the remaining proceeds.

A compromise between a non-participating preference and a participating preference is a *capped participating liquidation preference*. In theory, the benefit of a capped liquidation preference is that it allows the VC investors and the management to set a target value for a sale of the company below which the VCs reap the bulk of the return and above which the ordinary shareholders receive a substantial benefit. By using a capped liquidation preference, VC investors can provide an additional incentive to management to increase the value of the company. VCs can also avoid the seemingly unfair allocation of proceeds under a straight preference where the value of the company declines after the investment. There are numerous methods of implementing a capped liquidation preference, including:

- A typical capped liquidation preference comprises an initial payment of the preference to the VC investors, after which the VCs participate pro rata with the ordinary shareholders on a pro rata basis until the VCs receive a certain specified return (normally between two to five times their original investment, with earlier rounds usually having the higher multiples). After payment of the capped liquidation preference, the ordinary shareholders are entitled to share all remaining proceeds amongst themselves.

- A variation of the above capped liquidation preference comprises an initial payment of the preference to the VC investors, after which a payment of a similar liquidation preference is distributed to the ordinary shareholders on a pro rata basis, and then the preferred shareholders begin to share again on a pro rata basis with the ordinary shareholders (either with a cap on the return to the VC investors or not).

- A further variation is for the preference to disappear altogether (or be reduced) upon either a specific value being achieved in the sale of the company or at a specific date. The determination of the specific value is based upon the pro rata distribution of the proceeds to all shareholders being sufficiently large to ensure that all shareholders (including the preferred shareholders with a liquidation preference) receive an ample return on their investment.

In recent years, VCs have insisted upon multiple liquidation preferences: whereas a 1x liquidation preference would give a VC a preference equal to their original investment, in today's market it is not uncommon to see VCs demanding 2x or even 3x liquidation preferences. However, multiple liquidation preferences can backfire if they cause an "overhang" of investor preferences that may be too large to provide any meaningful return to management or the other shareholders (particularly in the context of a trade sale at a price that is less than the aggregate liquidation preferences of the preferred shareholders). In several recent instances, the VCs have been obliged to waive their liquidation preference in a follow-on investment to ensure a successful new round of investment (and a properly incentivised management team) or to "cut" the ordinary shareholders into the deal by allocating a portion of the trade sale proceeds to them (despite the fact that the ordinary shareholders may not be entitled to anything).

Finally, a liquidation event is usually defined to include a trade sale or merger of the company, in addition to a true liquidation or winding up of the company. Lately, however, some European VCs have insisted that a liquidation event also include an initial public offering. In theory, an IPO should not trigger a liquidation preference as a company should only go public at a valuation that would enable all shareholders (regardless of any preferences) to receive a more than adequate return on their original investment. Given the current state of the capital markets, it is unlikely that a liquidation preference will be utilised in the context of an IPO for some time.

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