BASIC LEGAL CHECKLIST FOR VENTURE CAPITAL INVESTMENTS

Typical Transaction Documents:

- Term Sheet
- Purchase Agreement
- Charter Document (e.g. Certificate of Incorporation, Articles of Incorporation, Amendment to Certificate of Incorporation, Certificate of Designation, etc.)
- Registration Rights Agreement (or Investor Rights Agreement)
- Stockholders Agreements (e.g., Stockholders Agreement, Investor Rights Agreement, Co-Sale and Right of First Refusal Agreement, etc.)

PROVISION	✓	WHAT IS IT?	WHAT ARE THE OPTIONS?	WHY IS IT IMPORTANT?	WHERE IS IT FOUND?
DIVIDENDS		A dividend is interest that accrues on a security.	A dividend may be paid in cash or as paid-in-kind stock. A dividend may be paid currently (a cash payment made to stockholders on a payment schedule) or may accrue until certain exit events (e.g., liquidation, redemption, conversion). A dividend may be compounding or non-compounding. A paid-in-kind dividend is by its nature compounding.	A dividend is a guaranteed annual return on the security being purchased, giving an equity investment a debt-like feature.	Charter Document
LIQUIDATION PREFERENCE		Upon a liquidation, dissolution or winding up of a company, the assets of the company will be distributed among its stockholders. A preferred stock will have priority in receiving distributions. Typically, the amount that the preferred stockholder receives is the price paid for the stock, plus accrued and unpaid dividends, although sometimes there can also be a premium included.	Al so-called "participating preferred" will have priority in receiving distributions, but then will also share in the distribution to the common stockholders on an as-converted basis. If there are different series of preferred stock, one series may have priority over another series upon liquidation, or all series of preferred stock may share equally in the priority distribution of assets. In some cases, a sale or even IPO of the company is considered a liquidation event, allowing the preferred stockholders to get paid first out of the proceeds of the sale or IPO.	Liquidation preference is important in a situation where the company is not as successful as initially planned. In an exit event (whether it be because the company has decided to liquidate or is sold), the preferred stockholders are guaranteed to receive proceeds before the common stockholders. This gives the preferred stockholders a debt-like feature (although preferred stock is junior to any actual debt of the company).	Charter Document

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CONVERSION RIGHTS		Often a preferred stock is convertible into common stock. The preferred stock is typically convertible on a one-for-one basis, but may also be convertible into more than one share of common stock	Some preferred stock is not convertible into common stock, preventing the holder from participating in any financial upside of the company's common stock equity. Preferred stock is typically convertible at any time at the option of the holder. The preferred stock may also be automatically converted upon certain events, such as an IPO. Sometimes the preferred stock is also automatically converted if a certain percentage of the outstanding preferred stockholders elect to convert.	The conversion feature of a preferred stock is important because it allows the preferred stockholder to participate in the financial upside of the company's common stock equity. The triggering event for automatic conversion is important because the preferred stockholder wants to insure that it does not lose its preferential treatment until the company has achieved certain financial thresholds (e g., in an IPO, that the company has a certain market capitalization, or that the stock sold in an IPO is at a price substantially higher than the preferred stockholder paid).	Charter Document

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ANTIDILUTION PROTECTION		Preferred stockholders are protected from “down rounds” and issuances of securities at a price lower than that paid for the preferred stock. This protection is effected by changing the conversion price/ratio of the preferred stock.	Antidilution protection is either “full ratchet” or is based on a “weighted average” formula. Full ratchet antidilution protection changes the original conversion price to the price being paid for the dilutive shares. For example, if the preferred stock was initially convertible into common stock at a 1:1 ratio (with the holder paying $1 for the preferred stock and the conversion price being $1) and the company issued additional stock at $.50 per share, then the conversion ratio would automatically be changed to 1:2, with the result that the conversion price would be reset to $.50 per share. A weighted average formula is based on an equation that reduces somewhat the conversion ratio, but does not take it all the way down to the new lower price. The amount of the reduction is a factor of how much dilution is actually experienced by the holder of preferred stock. There are typically issuances that the company is permitted to make at a lower price without triggering antidilution protection. Typical exceptions are stock options pursuant to the company’s board of director and stockholder approved option plan, stock issuable upon conversion of preferred stock or upon exercise of existing options or warrants, and stock issued in connection with strategic commercial transactions..	Antidilution protection is critical to protecting the preferred stockholder from issuances of stock at a price lower than that which was paid for the preferred stock This prevents the company from doing “down rounds” without adjusting the economics of the preferred stock, and also prevents the company from issuing so-called “cheap stock” in its sole discretion.	Charter Document

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GENERAL VOTING RIGHTS		Preferred stockholders are sometimes given the right to vote along with common stockholders on all matters put to the stockholders for a vote	Typically, preferred stockholders vote along with the common on an as-converted basis. Sometimes a preferred stock will not be a voting security, and will only have a vote on matters which by law require its vote or matters specifically requiring preferred stockholders' vote in the investment documents.	With voting rights, the preferred stockholders have the ability to vote on all matters put before stockholders.	Charter Document
PROTECTIVE PROVISIONS		A stockholder is given special voting rights with respect to certain activities of the company.	Protective provisions should at the very least include: changes in the terms of the preferred stock, issuances of securities senior or pari passu with the preferred stock, declarations of dividends on junior stock. Additional protective provisions may include sales of the company, incurrence of debt, sales of certain assets, etc. Protective provisions typically require a certain vote (majority or 66-2/3%) of the preferred stockholders.	Protective provisions give the preferred stockholder the ability to protect its investment. Depending on the extent of the protective provisions, they may also give the investors control over certain decisions of the company.	Charter Document; sometimes in Stockholders Agreement
BOARD COMPOSITION		Often an investor or group of investors is given the right to designate one or more members to the company's board of directors.	The right to designate a director or directors may be given to one particular investor or may be granted to a group of investors. In some cases, the investor's director designee also has the right to participate on board committees (e g , audit, compensation). In addition to or in lieu of a director, investors may have a right to appoint a board observer.	The board of directors makes decisions regarding the overall business and strategy of the company. An investor wants the right to participate in these decisions.	Stockholders Agreement; sometimes in Charter Document

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REDEMPTION		The company must redeem the preferred stock upon certain events or on certain dates. The redemption price is typically the price paid for the preferred stock plus accrued and unpaid dividends.	Redemption may be triggered by certain events (e.g , sale of the company) or a certain date (e.g , five years from the investment). The amount of the redemption may include a guaranteed “kicker” (e.g., 150% of the original purchase price). In many cases, the company is obligated to use its best commercial efforts to obtain outside funding to give effect to the redemption.	A redemption provision guarantees the preferred stockholder an exit in the future, giving an equity investment a debt-like feature.	Charter Document
INFORMATION RIGHTS		The company agrees to provide certain investors with certain information, including quarterly and annual financial statements, budgets, business plans, etc.	The right to information rights may be tied to a minimum ownership in the company. Information rights typically terminate upon an IPO.	Information rights guarantee investors that they are regularly informed of the financial and operational condition of the company	Stockholders Agreement

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CO-SALE OR TAG- ALONG RIGHTS		Certain stockholders are given the contractual right to sell when other stockholders are selling.	If one stockholder is selling to a third party, other stockholders may be able to “tag along” to these sales at the same price and under the same terms. Exceptions are often made for sales to affiliates or transfers made for estate planning purposes.	An investor will want to ensure that management or other key stockholders do not have the ability to exit the company, leaving the investor with a company different than the one in which it invested.	Stockholders Agreement
DRAG-ALONG RIGHTS		In the event that certain stockholders decide to sell their interest in the company, they may have the contractual right to force other stockholders to sell at the same time.	Typically this is a right only given to major stockholders of the company. In some cases, a stockholder may be forced to sell only if the sale would produce a certain return on such stockholder’s investment.	For a major stockholder, it is beneficial to be able to control a sale of a company, and to ensure that there will be no dissenting stockholders in such a sale.	Stockholders Agreement
PREEMPTIVE RIGHTS		A stockholder is given the contractual right to participate in future issuances of equity by the company.	Typically, a stockholder is given the right to participate in future offerings based on its proportionate holdings in the company (e g., if it owns 10% of the outstanding stock of the company, it has the right to purchase 10% of a new offering). There are exceptions to the right to participate in offering (e.g., for the issuances of options pursuant to the company’s option plan and issuances of stock upon exercise of existing warrants and options).	The preemptive right allows a stockholder to preserve its ownership percentage in the company. It also allows the stockholder to prevent unwanted new investors into the company, provided that it is willing to invest in lieu of such new investors	Stockholders Agreement
EXPENSES		An investor incurs expenses in connection with its investment. Such expenses include due diligence costs of the investor and/or its accountants, and the fees and expenses of attorneys.	In most cases, a company is responsible for reimbursing an investor for its legal fees and expenses, although there is often a cap put on such fees. Sometimes a company will also pay the other fees and expenses of an investor, but other times an investor may be responsible for its own costs. In some cases, an investor will receive a financing fee as consideration for making the investment.	Obviously an investor is very interested in having its fees and expenses paid by someone else. However, this should not be reason to incur unreasonable fees since the investor does have an interest in keeping down the costs of its new portfolio company.	Purchase Agreement