Future-Proofing: How To Plan a Successful Exit

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Planning for an exit has never been more important for venture-backed companies than in the current volatile climate — which, though unpredictable because of the COVID-19 pandemic's impact on the economy, is providing a unique opportunity for long-term exit planning. Exits in Europe and the United States are well off their 2019 pace by volume and dramatically down by value, as companies reflect, reorganize and delay planned exits until later in the year or into 2021. Meanwhile, the total value of venture capital fundraising increased in the first half of 2020 compared to the second half of 2019 in Europe, with pharmaceutical and biotech companies taking an increased share of the proceeds.

In addition, special purpose acquisition company (SPAC) initial public offerings (IPOs) have attracted investors and companies seeking to go public at a record-setting pace. A SPAC acquisition can offer companies and investors an alternative to the traditional IPO or sale transaction when considering an exit, providing cash to grow the business, an exit opportunity for founders and a resulting public company without some of the risks associated with a traditional IPO.

Amid this backdrop and myriad other attention-grabbing obligations of founders and their companies, ensuring that a company's venture financing documentation provides for a smooth and orderly exit remains essential. Below, we outline several key points for founders and their companies to consider to avoid unintended consequences as they approach an exit.

Upshot on the Down Round

Companies often offer anti-dilution protection to early investors with respect to future rounds at lower valuations in the hopes that valuations will increase and such anti-dilution protections will remain untriggered. Although down rounds as a percentage of overall rounds in the first half of 2020 were consistent with 2019, many companies will eventually need to raise cash even if at a lower valuation than their last round. Down rounds reveal the consequences of the choices made in negotiating the anti-dilution provisions of the financing documents. A full ratchet (where preferred stock is converted into a number of shares of common stock equal to the amount invested by the preferred stockholder divided by the price per share in the current round) can result in a significantly higher issuance of additional shares and further dilution to the founders than a broad or narrow, weight-based anti-dilution provision (which results in a smaller adjustment based on the magnitude of both the size and price of the down round relative to the size of the company's outstanding capitalization). The issuance of any other types of securities that may convert into common stock, such as warrants or convertible notes, may also trigger anti-dilution provisions. Careful messaging and open communication with existing investors helps maintain a positive relationship between founders and investors. Such communications may even lead to a waiver or renegotiation of the anti-dilution provision. Aside from the mechanics of anti-dilution adjustments, a down round may also have a significant impact on a venture capital fund's accounting with respect to the company.

Conversion Confusion

Just as companies should be mindful of how anti-dilution adjustments will work in different types of transactions, they also should consider how an IPO or acquisition will impact conversion or exercise features of convertible securities and warrants. Many early-stage instruments provide for automatic cashless conversion or exercise immediately prior to an IPO or change-of-control transaction. However, some instruments do not provide for,

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or are not clear about, this option. A lack of clarity as to what will happen to a company's convertible securities or warrants in an exit transaction can require additional negotiations with the parties and lead to uncertainty that can adversely affect the execution of the transaction.

Rewarding Employees

Stock options or grants to employees provide an essential form of compensation in companies with low or no revenue. The terms of those stock awards provide meaningful protection for founders. A "good leaver" clause will allow for the repurchase of stock, typically at fair market value, in the event of resignation for good reason or dismissal without cause. In contrast, stock held by "bad leavers" can be repurchased by the company at typically the lower of nominal or fair market value.

An IPO or acquisition requires the company to streamline and clean up the capital structure. Employee stock awards should be properly structured such that the share classes collapse into an efficient and marketable structure for an IPO. In addition, widely granting stock awards to employees with accelerated vesting if the company is sold may lower the sale price in an acquisition, as it requires additional capital from the buyer to retain these employees.

Navigating ROFRs, Co-Sales and Other Secondary Transactions

A company needs to balance the compelling reasons to facilitate and limit secondary transactions. Typically, early-stage documentation contains founder and shareholder lock-ups for an initial period, as well as co-sale and right of first refusal (ROFR) provisions that limit how easily current stockholders can sell their stakes even if no lock-up applies. If a company grows substantially following a funding round, it may wish to support an investor that wants to offload some of its shares, given its restrictions on investment value per portfolio company in the investor's fund documentation. A company should also carefully define triggering events so that a secondary transaction will not unintentionally lead to a vesting of stock or set a new reference point for valuation. In addition, the interplay of these types of provisions and the timing of an IPO or other exit should be carefully coordinated. Companies should evaluate the facts and circumstances when considering an acquisition of shares from investors pursuant to ROFRs, tender offers or similar purchases at a time when they are in discussions regarding an IPO or other exit or material transaction.

Permission Required?

Investors typically negotiate for voting rights over conversion of preferred stock to common, certain types of future financings and exits. Generally, founders should aim to limit these voting rights to events that directly affect an investor's economic rights or the terms of the investments themselves rather than give investors a potential veto over the day-to-day operations of the business. The company may also negotiate for a sunset on these provisions to preserve long-term strategic flexibility if the provisions are given in early-stage financing rounds. Furthermore, pre-IPO reorganization rights, including the right to insert a new IPO vehicle in a different jurisdiction, are essential in giving the company the ability to conduct an offering. A properly drafted preemptive inclusion in the agreement mitigates the time and cost of obtaining investors' consent for such a reorganization.

Investors may demand voting rights specific to their preferred stock or round of series financing to address the risk of undesirable changes to terms by a pooled vote of the preferred shares or the overall equity on a fully diluted basis. In particular, later-stage investors may seek series-specific voting over the issuance of new senior capital to preserve liquidity.

These limitations may be essential in getting early financing deals completed but may also limit the company's ability to conduct critical and necessary transactions — such as emergency financing and realization events — later in its life cycle. While major investors will invariably hold some form of consent right over exits, founders and companies should be cautious not to grant this so broadly that a wide range of smaller investors may carry a veto right. In addition, series-specific voting can jeopardize securing consent to a new round that requires modifications to existing rights, such as a waiver of anti-dilution adjustments. Another possible misalignment of early and later investors may occur over consent on conversion of preferred stock into common stock at sale, as economic returns may vary by series.

Unexpected Impacts of Registration Rights

Registration rights are a quirk of the U.S. markets. Venture investors, other key investors and significant shareholders typically require a company to provide them with registration rights for the resale of their shares as a condition of their investment. A company enters into a registration rights agreement with investors at the time of the venture financing, and the agreement typically provides investors with the right to demand that the company register the investors' shares with the Securities and Exchange Commission, have their shares included in any anticipated

registration or offering (so-called piggyback rights), and receive notice of upcoming registrations. In addition, registration rights may have provisions that require an acquiring company to assume the registration obligations for shares issued to the investors in the acquisition. Vague or poorly drafted registration rights provisions in the financing documentation can lead to unnecessary confusion or conflicts during an IPO or acquisition process. If not precisely drafted, it may be unclear whether investors have the right to receive notice of an upcoming IPO or to include their shares in the IPO itself, or the effect that an acquisition would have on the registration rights. In addition, subsequent rounds of financing should be attentive to what registration rights have already been granted and ensure the provisions are harmonized.

Planning for the Next Stage

Current market conditions are providing a unique opportunity for companies to evaluate the different types of exit alternatives and plan for a transformative transaction with traditional exit opportunities being delayed. As companies approach a potential exit — whether through a traditional IPO or sale process, or a SPAC acquisition — reflecting on these points as well as engaging advisers to review the existing documentation and capital structure remains essential. Careful messaging and communication among the company's constituents — including the founders, board, management and investors — also is important in setting expectations.

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