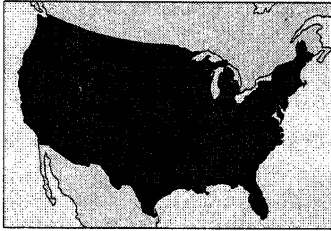


United States

PROTECTING THE PRIVATE EQUITY INVESTMENT WITHOUT KILLING THE GOLDEN GOOSE



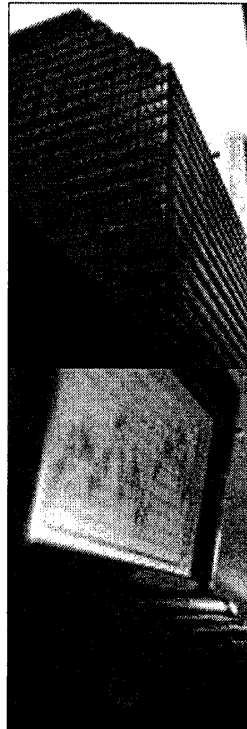
**By Stephen M Davis
and Kenneth Drake,
Heller Ehrman White &
McAuliffe LLP**

The economic downturn over the past two years, coupled with a market meltdown and the absence of investment exits, has led to the worst private investment environment in decades. Many follow-on rounds during the last two years have been “down-rounds”, where all existing equity holders have shared the pain and been adversely impacted. With the substantial decline in private company values, institutional investors have increasingly been imposing stringent terms on their investments directed at preserving their potential economic returns. These terms typically come at the expense of junior security holders principally management, including the founders and key employees and frequently create unhealthy, if not potentially company-threatening, dynamics. This article will review some of the popular structures and provide recommendations to balance the needs of the two primary private issuer constituencies - the investors and the employees.

While the fact that a company faces a down-round for obtaining financing would be bad enough for all existing shareholders, institutional investors offering to fund the company often require other harsh terms. These terms are typically aimed at the investor preserving as much of an economic interest in the company as possible after a subsequent round at a

lower valuation, correspondingly, at the expense of junior preferred holders, common shareholders and option holders. Some frequently used examples of these terms include “full ratchet” anti-dilution adjustments, super-multiple participating liquidation preferences and short-time frame mandatory redemption.

With respect to anti-dilution protection, institutional investors will require an adjustment to the number of shares they purchased in the event the company sells additional shares in the future at a price per share lower than the price per share that the institutional investor has paid. Mechanically, this occurs through an adjustment to the conversion price of the convertible equity security purchased by the institutional investor (ie lowering the conversion price so that the institutional investor would be entitled to more shares upon conver-





sion). Historically, private equity investors have employed a weighted-average capitalization formula in private equity investments that calculates the true economic impact of the subsequent investment on the existing preferred investors and adjusts the conversion rate on the existing preferred stock based on the then number of shares of common stock deemed outstanding and the size and pricing of the subsequent investment. Consequently, the weighted-average formula applied to a company that is issuing a small number of shares in a down-round but that has raised significant capital in prior offerings would result in only a minor reduction in the prior preferred stock's conversion price.

With the fear of a down-round in mind, investors are now frequently requiring an anti-dilution protective provision known as the "full ratchet". A full ratchet requires the company to adjust the shares previously purchased by the institutional investor so as to be equal to the number of shares the institutional investor would have been issued had the institutional investor purchased its shares at the lower price in the subsequent investment; in essence, a "do over", or mulligan, on valuation. This type of a punitive provision can cause substantial dilution to the company's junior equity-holders irrespective of the economic impact on the company's capitalization. In the example above, the result with a full ratchet could be substantial dilution even if few shares were issued in the subsequent transaction.

Another hot button for institutional investors has been the use of the super-multiple participating liquidation preferences. Liquidation preferences are generally triggered by certain events, such as liquidation, sale of all or substantially all of the assets of the company, the acquisition of the company, or a merger or consolidation. They set up a "pecking order" or priority on distributions with respect to equity. Historically, liquidation preferences were meant to assure that private equity investors would receive at

least their purchase price back before other junior shareholders were to receive any return on their equity. The standard provision would entitle the preferred holder to receive its purchase price plus accrued dividends before letting junior classes of equity to participate in distribution or, if it would be more beneficial, the investor would be entitled to convert into common stock and receive a pro rata distribution along with other shareholders. In recent years, there has been movement to participating preferences, which entitles the investor to a return of its investment and then participation with the shareholders in the company's remaining assets and, more recently, to super-multiple participating liquidation preferences that entitles the investor to a multiple of its investment before any participation by a junior equityholder. Depending on negotiations, there are many forms a super-multiple participating liquidation preference can take, including an institutional investor being entitled to not only twice, three times or higher multiples of its investment, but thereafter also being entitled to participate on an as-converted basis with holders of common stock in any remaining distributions. As a simple example, if a preferred investor negotiates a three times multiple on a participating liquidation preference in a \$10 million investment for half the equity of a company that is subsequently sold for \$40 million, the investor will be entitled to a \$35 million distribution and the junior equityholders will be entitled to \$5 million.

Recently, institutional investors have been requiring that their investment security have a mandatory redemption date no more than a few years after the investment. This provision provides an institutional investor with a put right to the company exercisable after a specified period of time requiring the company, in its most frequent form, to return the institutional investor's investment (plus accrued dividends). If exercised by the preferred holder, the investor becomes a creditor of the company, senior to every other equityholder, which could impair the company's likelihood of receiving any future outside financing.

While institutional investors certainly have many issues with providing down-round financing, it is important to remember that not too long ago, a significant element in any private equity financing was to ensure that managers and employees were incentivized with equity, aligning employees' interests with those of the investors and providing employees with a substantial equity upside in the event of an IPO or successful exit by the company. If the investors are too successful in achieving the protections described above, there is a significant danger that the principal goal of the institutional investor, achieving a successful return on its investment, will be at risk. Sure, institu-



tional investors will argue that new money should not be assuming valuation risk. But, if any of these protections are triggered, employees will quickly realize that the likelihood they will receive any return on their equity is remote. The morale of the employees may be harmed to such an extent that it will adversely affect the operations of the business and, consequently, future valuation and the likelihood of a successful investment. In this scenario, unless the managers and employees can achieve some incredible increase in the value of the company (such as a five or 10 multiple), managers and employees who have sacrificed higher compensation for equity will receive nothing from their equity. Certainly, in the present poor economic environment, employees and managers may not have any other place to go but, when the economy improves, these managers and employees will seek employment elsewhere where they can obtain equity that has an upside. Therefore, what needs to occur in investments during challenging economic times is a structure that balances the investment protections for the institutional investors while still leaving enough money on the table to motivate the managers and employees.

Some recommendations that we advise investors

to consider when they negotiate their next financing are as follows:

- use weighted-average anti-dilution protection with carve-outs to the application of such provision, such as issuance of options to employees, issuance of equity securities as part of a strategic transaction etc or if a full ratchet is used, limit it to a short duration (eg one year) with a "pay-to-play" component that requires the investors to take part in the subsequent financing in order to maintain their anti-dilution protection;
- cap what the institutional investor can receive in a liquidation or provide that the liquidation preference disappears in the event the value of the company exceeds a certain dollar amount in an exit transaction, thereby assuring that the investor receives a healthy return while preserving a meaningful return to the junior equityholder;
- extend the date of the mandatory redemption to no less than five years so as to allow the company enough time to execute its business model and realistically reach an exit;
- provide a "carrot" to the managers and employees in the form of new options to purchase shares of the same security being purchased by the institutional investors and exercisable at the price a share paid by the investors (or at a slight premium thereto); and
- if the employees' equity is well under water, consider a "change of control" compensation plan for key employees who will be compensated if the company is sold during a specified period of time above a certain threshold.

Of course, investors and companies will have their own issues and dynamics as they negotiate their financing. But, based on recent activity that we have seen, it is imperative that the institutional investors and the managers/employees find a way to balance the risks and rewards of their relationship or otherwise be faced with a significant obstacle to achieving success. This balance will help preserve the golden goose.



About the authors

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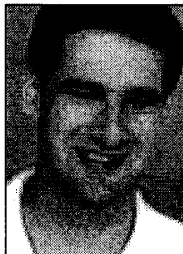


STEPHEN M DAVIS

Heller Ehrman White & McAuliffe LLP

Stephen M Davis joined Heller Ehrman in 1999 as a shareholder in the New York office and is co-chair of Heller Ehrman's Private Equity and Emerging Companies Group. He has extensive experience in several areas of corporate practice with a focus on private equity, venture capital, corporate finance and securities, and M&A. He has represented clients in transactions ranging from start-up financings to \$1 billion plus public offerings and has counseled companies in many diverse industries. Mr Davis has represented issuers and underwriters in numerous IPOs and acts as outside general counsel to several public and private companies. Mr Davis is a frequent speaker at industry and legal conferences, has written articles for publications and is often quoted in business publications. Mr Davis received his BA from Columbia University and JD from Columbia Law School.

KENNETH DRAKE



Heller Ehrman White & McAuliffe LLP

Kenneth Drake joined Heller Ehrman as an associate in the New York office in July 2001. Before joining Heller Ehrman, Mr Drake served as consultant and corporate officer to several business ventures and start-ups. Before that, Mr Drake was a corporate associate with a major national law firm, where he specialized in public equity offerings, corporate M&A and leveraged buyouts. Mr Drake received his BS from State University of New York at Binghamton and his JD from Columbia Law School.