An Interview with Brette Simon

Brette Simon, Partner, Jones Day, speaks with Growthink University's Dave Lavinsky

Dave Lavinsky: Hello everyone Dave Lavinsky here from Growthink and I'm really excited today to be able to interview Brette Simon.

Brette is a partner at Jones Day which is a top tier law firm with offices in New York, Los Angeles, Silicon Valley and several major international cities. Brette advises companies and investors on private equity and venture capital financing. She's on the venture capital and private equity committee of the American Bar Association. She's also a member of the Los Angeles Venture Association.

Brette was recently recognized by *The Deal,* which is a popular venture capital and private equity publication, as one of the top thirteen deal makers in the country, which is obviously very impressive.

So naturally based on Brette's background I thought she would be a perfect person to interview today about the legal aspects of raising venture capital. So I'm really excited to do this interview. Brette, thanks again for taking the time to speak with me today.

Brette Simon: My pleasure.

Dave Lavinsky: Excellent. So let's start at the beginning. Are there certain advantages that different corporate structures offer when raising venture capital? And if so, could you briefly explain them?

Brette Simon: Sure. So broadly defined there are sort of three buckets of choice of entity that one can make, and I'll talk briefly about each one.

The first is what's known as a C corporation, the second is an S corporation, and then the third is an LLC or limited liability company structure. S corporations should not be used generally speaking because as soon as you have institutional investors, the tax rules for an S corporation preclude anyone other than individuals and certain types of trusts.

The minute you go to an institutional investor such as a venture capitalist or other type of institutional investor you wouldn't be able to use an S corporation. From the get-go that's not an advisable form of entity. Founders sometimes think that would be a great type of entity because it's a "pass through" so on one level you're eliminating one level of risk but you're setting yourself up for problems down the line.

My advice to founders is do not set yourself up with an S corporation. You're just setting yourself up for problems down the line. You then can go to a limited liability corporation where you do have pass through treatment on the tax front and you can also take in any type of investors. I've done deals with LLCs with venture capital investors; however, it's still viewed as sort of an anomaly.

I think from a comfort factor, most investors prefer the good old fashioned C corporation especially if you're going to go public at some point, you've got the right entity to use for a public entity. There are issues even with institutional investors who can invest in an LLC. It's not precluded by the law; however, there are other issues which will quickly get beyond the scope of this discussion.

But people have heard of unrelated business tax income for example. This creates problems for an institutional investor to invest in a pass through entity. They have to set up complex structures to avoid having pass through income which can cause problems for their limited partners. All of that gets much murkier than anybody probably wants to spend the time or money or brain power dealing with, especially when you're dealing with a startup and a small entity.

This is more frequently done when you've got a more established or later stage company that's taking in bigger rounds of capital and it might make sense to think through all of this. But at the early stages, good old fashioned C corporations [is best because] everybody is familiar with it. Regarding the case law, there have been cases decided in connection with entities. People are

familiar with the outcomes of those cases. When you're doing incentive stock option plans people understand what those are.

If you're doing an LLC you have to explain to the employee what a profits interest is. It's just less – the vernacular is less familiar. It can be done but for all those reasons people tend to end right back up at the C corporation. In terms of what states incorporate in, you can certainly pick any state. People tend to do Delaware. The law is well established there.

If you're ever going to go public you don't have to reincorporate. Most IPOs and most publicly traded companies are Delaware incorporated companies. Again, there's a familiarity to it. Different states have quirky aspects of their laws. If you're not intimately familiar with the laws of the state, [they] can be "gotchas."

I practice in California. We certainly incorporate in California as well, although California has some peculiarities you have be mindful of. The lowest common denominator that everybody knows and is familiar and comfortable with is Delaware. That's why most people tend to incorporate in Delaware.

Dave Lavinsky: Got it. Now what if a company is incorporated as an S corporation or they think that they're not going to raise capital possibly this year or they're going to wait until next year and they want the benefits of an S corp.? Is it possible or easy to start as an S corp. and then change over to a C corp. thereafter? Or is that something you want to avoid?

Brette Simon: You could do that. I would suggest if you're going to go that route, probably start out as an LLC and then convert to a C corporation. What you need to do at that point, what I would do at that point is talk to my tax colleagues. There are tax implications either way when you convert from an S corp. to a C corp. or from an LLC to a C corporation.

It's sort of beyond the scope of this discussion but it depends upon whether you have something called earnings and profits and certain type of assets, whether they're capital assets or ordinary income assets and how those are taxed. Again it really behooves you at that point to have your lawyer talk to one of their tax colleagues on that front. It absolutely can be done. It's just more cost. It's just more hassle.

The benefit to the S corporation really comes into play if you're doing an exit event and you're selling because then you don't have the double layer of tax at that point. It's less of an issue if you're not making any money. If you have single layer of tax but early stage companies are generally generating losses and the ability to use those losses to offset your personal income is limited in any event. You might be better off leaving those losses in the company and if you're generating operating losses you can use those later on depending on the type of transaction you do later.

Again, the pass through nature I think can be deceiving because people think "*Oh that's fantastic only single layer of tax.*" When is that relevant? It's relevant when you have gains. If you're a startup that doesn't have gains, it's less of an issue. You may be blowing your ability to use losses down the line.

All this really comes to play when you have an exit like the sale of a company. If you're selling assets then it's relevant but that's many years down the line and by that point you've probably taken in institutional investors and had to convert to a C corp. anyway.

Dave Lavinsky: Got it. Okay. I appreciate you going over that.

Brette Simon: Sure.

Dave Lavinsky: Overall, it seems a lot simpler to incorporate a C corp. at the beginning and things are a lot smoother from there. Correct?

Brette Simon: That is correct.

Dave Lavinsky: The next question I have – and this is a question that's on the minds of a lot of entrepreneurs – is what steps can entrepreneurs take to protect their business ideas or their intellectual property when going through the capital raising process?

Brette Simon: Are you saying protect their IP vis a vis the potential investors or are you saying just as a general matter what should they be doing to be thoughtful about IP portfolio protection?

Dave Lavinsky: I think it's a general matter. A lot of entrepreneurs have their concept, their idea and they're very nervous telling anybody, pretty much beyond a lawyer that they know can't tell anybody else. They get very nervous about someone stealing their idea and they get very nervous when they have to start presenting it to a lot of different people.

Brette Simon: Sure. A couple things – one is, anytime you share any asset of your intellectual property with another party, and I'm sure most of your listeners and readers know this, but they should have the other party sign a non disclosure or confidentiality agreement. Counsel can certainly prepare a form of that so they have a template to use and anytime they use a developer, a supplier, a consultant, anytime they're going to be sharing the secret sauce, get an NDA signed.

Now it's only as good as the paper it's written on, so if you're not comfortable with this person and don't trust them, don't do the deal. Obviously you don't want to get into a situation where you have to enforce it with litigation because that's ugly and expensive. Once it's out of the bottle it's very hard to put it back even when you have an agreement in place. Those are the types of things that are tough. You can't put the toothpaste back in the tube as they say. It's only as good

as the paper it's written on in terms of you have to trust and be confident who's on the other side of that.

The other thing to do though just from a smart perspective is you're going to be raising capital later or not, but get your ducks in a row in terms of get your employees and your consultants and your vendors and everybody to sign proprietary information and assignment agreements, because what often happens is, it's a startup, everybody is doing things fast and quick and dirty. We'll dot the "i's" and cross the "t's" later.

If you're a company whose real asset is your IP and you haven't had those agreements properly signed and then you go raise capital or you go to sell the company or whatever down the line, it turns out those people who were integral in helping develop the IP may have rights in that IP and can hold the company hostage and have leverage over the company because now you have a fight about who owns the intellectual property. They've gone off and started a competing business. They now work for another company that's using that IP.

You want everything that they do absolutely assigned and transferred to your company so it's clear that the company owns it and there's no debate over, "*I did this at home on my own time or I was moonlighting or this wasn't exclusive. I was consulting for four companies and it's all mine.*" You never want to have that. That's a deal breaker for an investor. It's a problem to grow the company and be successful and to protect your IP.

Another question we often get is should we file a patent? It is important to do an audit of your IP and decide whether you want to pursue a patent strategy. Not everybody does because filing patents means disclosing your IP. It's incumbent again, and this is not to pitch lawyers, but we are useful creatures at certain points in the process. One of those points is having your IP attorney come in and talk to you and go through a discussion about it because it may be that you don't want to file patents.

It could be intellectual property that isn't easily patentable. Not everything is subject to the patent laws and can be patented. It may be that you're better off protecting it as a trade secret in which case you set up procedures and policies internally to protect those trade secrets. If it's secret sauce to your invention you keep the ingredients or the source code, or what-have-you, under lock and key. Only certain people have access to it. There are a certain number of keys to the cupboard so to speak.

Again you have people sign nondisclosure agreements. You conduct exit interviews when they leave. You make sure that they're not taking laptops with the information. There are all sorts of procedures and methodologies that if you follow that you're less in the likelihood that you're going to have problems down the line. It's not always "run to the patent and trademark office." You should analyze what the most appropriate program is to protect your IP.

Once you bring in potential investors whether they're angels or ventures capitalist, the other thing you can do, and this is especially true if you're bringing in a strategic investors... Financial investors generally aren't off inventing things on the side but if you're going to potentially partner with a strategic investor who could be a competitor, you want to stage the diligence, so they only get access to your most proprietary data at the tail end of the process when you're pretty comfortable that they're going to do the deal and they're not just kicking the tires to see what you have.

You can stage the diligence. Often we don't provide customer lists until the very end. You can have them look at the IP again later on in the process when you're relatively comfortable they're moving forward with the transaction. Staging the diligence process is another method. In terms of providing access, they can look at the information. They can't take copies with them. Somebody is in the room when they're looking at it. Or if you're setting up a virtual data room they have a

right to read it online but the feature to download and print is disabled. There are different ways to try to limit leaks. .

Dave Lavinsky: Got it. The staging diligence concept, I guess that's the same concept you would use for venture capitalists that wouldn't sign a nondisclosure in the first place. Is that correct?

Brette Simon: Yeah and that's true. Not all VCs will sign them. Some of them have no problem signing them. Some of them refuse to sign them. If they refuse to sign them you still have your rights under law in terms of somebody stealing your intellectual property or taking trade secrets.

Another way to deal with this if they won't sign an NDA is, like I said and what you just mentioned, staging the diligence so they're only looking at your true secret sauce in the latter stage of the diligence process.

Dave Lavinsky: Excellent. One of the first things you started talking about was proprietary information and assignment agreements. Are these agreements woven into employee contracts and independent contractor agreements or is this a separate agreement you like to use?

Brette Simon: They can be. I typically have a separate agreement. It depends. Many employees don't really have an employment agreement per se because they're just at-will employees. If they do have an employment agreement then you can weave it into their employment agreement but often somebody is just getting an offer letter and then there's a whole separate PIIAA (Propriety Information and Invention and Assignment Agreement), one for employees and one for independent contractors because there are slightly different provisions for each. They run a handful of pages in terms of all the provisions that you need in there to protect the company.

Dave Lavinsky: Got it. I'm assuming that the venture capital firms will look at these. It's PIIAA?

Brette Simon: PIIAA. Proprietary Information and Invention Assignment Agreement.

Dave Lavinsky: I'm assuming as part of the venture capitalists' due diligence process they would like to see all these agreements.

Brette Simon: Absolutely. And if they haven't been signed, they will make you go get them signed or you can end up in just a difficult situation because they want the company to take the risk that if there are any problems they will indemnify the venture capitalists.

The venture capitalist will say it's not enough to just have the company indemnify me because that's just like me indemnifying myself. I'm putting my own money in and I'm going to indemnify myself with my own investment. They'll often ask the founders to stand behind that now you have the predicament of individuals being jointly and severally liable. They potentially have to bear the expenses if there's a problem down the line. That's just an open-ended mess.

If your fundamental IP is really what the business is all about and the value is tied up in it, and somebody has taken that intellectual property, damages can be immense and very hard to quantify.

Dave Lavinsky: Got it. Thank you. What are some of the main laws and regulations that entrepreneurs need to know about and act in accordance with when raising capital?

Brette Simon: Some of the laws?

Dave Lavinsky: Correct.

Brette Simon: We just talked about the intellectual property perspective, but the other major issue that tends to come up is securities laws, because again people are operating in a fast and loose environment and founders will often just sort of issue shares without thinking about the securities laws implications.

Again that can cause problems down the law. If you issue too many shares at some point if you're over three hundred shareholders you actually could trigger the Securities and Exchange Act of 1934 and require registration which is certainly not what anybody wants to do. You have to keep track of your shareholders.

In California, at least, the ability to issue the number of options you can issue, there are certain limits on that or again you violate the securities laws. We usually set up some sort of Excel spreadsheet so you can track how many options you're issuing in any rolling twelve month period because otherwise you're violating securities laws.

If you've issued securities to people who are unaccredited and they didn't fit in within another exemption in securities law you violated securities laws. When this comes up and it's an issue, further down the line when you have an institutional investor and they're doing their diligence and going through everything and they see that there weren't valid security law exemptions for the issuances you potentially have to deal with what's called a rescission offer which is a very expensive process.

You have to go back to all your old investors and buy them out of their shares at the price they paid. That's expensive. It can be expensive depending on what they paid. That's not really what you want to have happen when you want to get a deal done quickly and you're burning through capital and you want to get to the next round of financing and get that closed, nobody wants to do a rescission offer.

Again this is where the lawyer is helpful, making sure that you're not issuing them to your receptionist and the janitor and your uncle, all of whom are unsophisticated investors. There are some limited ways to issue to unsophisticated investors but they still have to have some level of financial and business experience, at least as an example in California, that gives them adequate ability to evaluate the investment. They have to have some connection with the company so it can't just be someone who is unsophisticated who has no relationship with the company.

That's a big one and then just kind of mocking up your cap payable. If you issue to too many people you end up with too many cooks in the kitchen. You have to get consents and approvals for certain actions. Then you have to corral a hundred people who are spread out across the country. Then you have corporate governance issues because let's say you need majority approval to bring in a new round of financing, or to amend your charter, and somebody owns two shares and that two shares are what's holding up your entire transaction and you can't find them or they try to exact leverage and say, "*Obviously I'm an important part of this, I want X if you want my approval.*"

So you want to be careful who you issue shares to, for all those reasons, because without realizing it you can hold up your ability to grow the company and do future transactions.

Dave Lavinsky: Excellent. What about documentation? With some investors, you need a business plan. With other investors you need the Private Placement Memorandum. Can you talk about the documentation you need to raise venture capital?

Brette Simon: Sure and it's all over the map. There's no one size fits all. I often say to people you need to know what you're doing, and have models and projections and have financials and have analyzed the market.

Initially though, I would say to have an executive summary or teaser ready because an investor will only have the time and desire to look at a one or two page document. They'll decide based on that whether they want further information. If they do then you can send them your full business plan as well as a nondisclosure agreement to the extent that they're willing to sign one.

But I would start with a teaser because again that will determine in most cases whether somebody is interested or not to move further. I generally, and again this doesn't help me because I get paid by the hour, but a PPM is an expensive document to create and so many times I get referred to clients who say, "*I spent $40,000 putting this thing together. It wasn't really successful. I look at it and it's not well done and nobody really cared and nobody really needed to see that.*"

An executive summary plus a business plan is really what investors are looking for. A PPM is beneficial in the sense that usually it has in there all the risk factors and all the disclaimers and all the things that lawyers like to see in terms of qualifications. You are better off if somebody ever tried to sue you for fraud, the argument being you didn't disclose this or you failed to provide material disclosure or you omitted a material item, you're certainly better off if you've done a full blown PPM.

I just think candidly it is overkill, and if you are not committing fraud and you're doing a good job of providing the basic risks and facts surrounding the investment, you're going to be fine. It takes a lot to be able to prove fraud. You have to be doing pretty bad things to commit fraud, so I like to believe most people are not committing fraud. Short of that, you're going to deal with all this in the stock purchase agreement in any event, and that's where everything will get fleshed out with disclosure schedules and the stock purchase agreements.

Those reps and warranties will say that the only things that the investor is relying on are the reps and warranties in that agreement. We can't pull in prior PPMs

and other documents in any event. I think you're covered there. I think it's less money for the founders to spend in terms of waste. I think that's the more practical approach to go – executive summary, have a business plan ready. You don't really need a PPM. It's expensive and I don't think it necessarily gets you anywhere at the end of the day.

Dave Lavinsky: I'm assuming you definitely don't want to present a PPM to a venture capitalist. Is that correct?

Brette Simon: You can but I almost think if you present one they might sort of scratch their heads a bit because again they're used to seeing a teaser or a summary. If you've gone through all of that ahead of time you may be completely off. You may have no sense of what investors are really looking for. You may not be headed in the right direction if you spent all this time and money putting together a beautiful PPM that nobody wants to read, that nobody is interested in because they're not even going to get past the executive summary.

Dave Lavinsky: Got it. Excellent. So let's say we have our executive summary. We have our teaser. We get that in front of the venture capitalist. They're interested. We get to the point where the venture capitalist sends over a term sheet. They send it to me and you're my lawyer and you start looking at the term sheet. What are the first things that you're looking for in the term sheet as my counsel?

Brette Simon: As the company counsel?

Dave Lavinsky: Correct.

Brette Simon: There are a lot of things that are sort of standard and more boiler plate. One of the important things to look at, and this will be one of the first things you see there. There are a couple things.

One is the valuation of the company and what they're willing to pay for the company, how big a piece of the company they're taking in exchange from their investment. Ideally you have a couple of term sheets or you have friends who have taken money and you can kind of get a flavor for if they're in the realm of the market or not.

It is certainly not an exact science. People ask me how you value a company. At an early stage, it's tough to say what it's worth. That's why you hopefully get a sense of the market – you collect a few other term sheets. You talk to other people and what they've gotten in their rounds in comparable industries. You look for valuation.

Then you look at liquidation preference, because at the end of the day, that's where the investor gets their pound of flesh. Do they just get their money back? Do they get 2X their money back? Do they get their money back plus an accruing dividend, a coupon, like an interest rate making it more like a debt instrument? Do they get their money back and do they get to participate?

Participating preferred is where they get to "have their cake and eat it too," where they get to keep all the rights of a preferred stock holder, get their money back and then collect additional liquidation proceeds as if they had converted to common, but they don't have to convert to common. They get to stay as preferred, get all the rights, preferences and privileges that preferred stock holders have, and then double dip and get the funds that they would have gotten had they converted to common.

Sometimes participating preferred is capped, but a lot of times it's not capped. Then they literally can have their cake and eat it too and get all the money they would get as a preferred holder, and all the money they would get if they had instead converted to common. You have to be very careful about a participating feature because that's a very rich provision.

Then I mentioned dividends – are they mandatorily accruing? In many cases you'll see it's as, if, and when declared by the board. If the board never declares a dividend, there is no dividend. A lot of times you'll see phrases like mandatory or cumulative dividends, in which case it's sitting there accruing even though a board never declares it.

So, when there's an exit event not only do they get their money back, they get eight or ten percent of whatever that rate is compounded from the commencement of the investment through the exit date. That's another piece to look for. As you add all this up, this is all coming before the common [shareholders] ever sees a dollar.

The other thing to think about if that's a Series A for example, how is that going to look to future rounds of investors? Depending on how things look in terms of who gets out first, the A, the B or the C round, they may like that and say, "*We'd likely to have the same terms. We'll participate too and take our ten percent*" or whatever. Or the B Round and C Round may say, "*That's too rich. We're not going to take that but we also want to make the A round waive their rights to that.*"

If the A is smart and they want the company to grow and be successful and they want additional financing, they should be amenable to the future rounds' terms. But if they're greedy and want to hold fast you end up in that debate. You have those issues.

The other issue is if there's a redemption feature, a lot of times the venture capitalist will say if there isn't an exit round if five years, seven years, what have you, we want to get our money out plus a premium perhaps. That's sort of a gun to the company's head because in five to seven years if things haven't gone well you have to buy out the venture capitalists. Do you have the money to do that? That's something to be thoughtful and look for the redemption provision as well

and maybe you say that you pay that over time, if not a bullet because you may not have the funds to pay it out all at once.

The other thing is the anti-dilution provision which is if there's a round of financing with a valuation that's lower than this round, how rich is the anti-dilution protection meaning there are broadly defined two concepts – one is full ratchet. One is weighted average.

Full ratchet is very beneficial to the investor and it's very draconian. If you look at most VC deals, in fact there are surveys done, very few even today, even with the tough economy we're in right now, very few are full ratchet because it's so draconian. Full ratchet means if the A round was at $5 a share and somebody issues one share at $4 a share then the entire A round that was $5 is really now an effective price of $4 for conversion purposes.

Let me give a different example. It's gone from $5 to $2.50. Now the A round basically gets to convert into twice as many shares as it did before in terms of the conversion price. So, a more fair and equitable approach is to say, "*Wait a minute. Only one share was issued so on a weighted average basis that really means it goes from $5 to $4.97. Let's look at how dilutive that issuance was. It was only one share.*"

Weighted average takes into account the old price, the new price, how many shares are being issued in this new round. Weighted average can be broad based or narrow based. The broader the base, the less dilutive it was and the less the conversion price goes down. For companies, they ideally want a weighted average broad based anti-dilution provision, because that is the most pro-company.

The bigger the denominator – if you include in the denominator not just common, you add in preferred, then you add in presumed exercisable warrants and convertible securities – now we have a pretty big pool of shares in the

denominator. So this down round didn't affect the prior investors so much because the base is so broad. But if you only look at common as the base or preferred as the base, that is a much more dilutive issuance because the pool is much smaller. That's a narrow based weighted average provision.

The goal for the company is never do full ratchet if you can avoid it. Within the world of weighted average, do broad based. If someone tries to stick a company with a full ratchet anti-dilution provision, what I would at least say is that only applies for the first year or until we get to our next financing round. The argument sometimes will be, "*How do we know if we're really valuing the company properly?*"

It's early stage, it's Series A. Who really knows what the company's worth? Until we have our second round, that's really the determining factor what value is. We may have been off by a material amount. If we said $5 and it's really $3, we want to be able to go down to $3. If you allow that at all, you only allow it until the next round of financing and then the full ratchet goes away.

That's one compromise, but again it's a pretty rare provision and I would fight pretty hard not to have that in the documents. Those are some of the main areas.

The other area is board seats. You want to be careful that the investor isn't taking control of the company. Usually there's an independent seat and you want to make sure you have the right to agree with them on who that independent seat is.

The other part of it is reverse vesting of shares. It's very common for investors to demand that founders have reverse vesting on their shares. You want to look at that and look at how long the vesting period is and does it accelerate in certain cases if there's a sale of the company or if they're terminated with cause, etc.

Dave Lavinsky: Got it. Very helpful. Now what do negotiations look like if you only get one term sheet versus many? Obviously if you only have one term sheet

you have less negotiating options. What terms can be negotiated and to what extent?

Brette Simon: They're all potentially negotiable. Some of them you don't really care about so much.

I don't worry too much about registration rights because they're rarely exercised and they're pretty standardized so I don't worry too much about registration rights.

Liquidation preference, that's a business term so that's value. How much are they going to get back?

Dividends, same drill. You can try to negotiate how many board seats they have.

Information rights are another area. How much information do you have to provide them? How frequently do you have to provide it to them? That can just become a very burdensome request so that's an area you can usually have some play with.

The other area is protective provisions. The shareholders in addition to having board seats they want to have certain veto rights over material transactions. That's another big area that gets negotiated. How long is that list of rights? How long is the list of material events they have approval rights over?

You can often begin there, even if it's a material event like the sale of the company, if it's a sale of the company but they're going to get four x back or some really phenomenal term then they don't have approval rights. All they should care about is they're getting their money back at some nice return.

It's not, "*We don't like this group*." You don't want them causing problems. You can sort of bake in there that all things being equal, they're getting their money

back plus some return that they're happy with, they shouldn't have an approval right. There is usually some negotiation over protective provisions and what items they do and don't have approval rights over.

I'm just trying to think of what else... We've talked about liquidation preference.

Redemption: you can try to have that eliminated or it doesn't kick in until seven years out and even then it's paid over time.

The other things that get negotiated are what's carved out from the anti-dilution protection. Certain transactions shouldn't give rise to a dilutive issuance that triggers the anti-dilution protection. Then it's a question of what's the size of the option pool that's exempt.

What if it's a merger and acquisition transaction and you're issuing stock? Does that count? What if you're issuing shares or warrants to a debt provider or to a consultant?

There's sort of a whole litany, laundry list of items the often can be negotiated out of the anti-dilution protection so that those don't trigger the anti-dilution protection.

Those are some of the main areas. There are employment agreements often in place. A lot of the terms of those can be negotiated in terms of severance and how do you define cause and without cause termination? Those are the main ones.

Dave Lavinsky: Excellent. That was very comprehensive. I appreciate that.

Brette Simon: Sure.

Dave Lavinsky: When you're working with entrepreneurs and company management teams going through this process, are there any big misconceptions that these entrepreneurs have about this legal process, when it comes to raising capital, that you think should maybe clear up in the minds of the entrepreneurs listening to this call?

Brette Simon: That's a good one. I'm trying to think of what their misconceptions would be. It can be on two spectrums I think.

Sometimes people are too naïve and unsophisticated and trusting about things. On the other side I think some entrepreneurs are too skeptical and paranoid. You want to move each group to the middle. You don't want to be taken advantage of but you also have to be wiling to compromise and realize people are trying to get a deal done and are not trying to screw you so to speak.

I think it's just a question of mindset. I've dealt with founders that just don't trust anything. It just makes the deal very difficult and it adds to deal cost because they're uncomfortable and any provision that is even remotely pro-investor becomes difficult for them to swallow.

And look, they're giving you money – they're going to take a chunk of the company. You kind of have to accept that at the outset. If you can't accept that then don't bring in venture capitalists because they are going to be on the board. They are going to be rolling up their sleeves. Hopefully that will be a positive relationship because the goal is they introduce you to other strategic partners and they help you grow the company and they provide a level of adult supervision that wasn't there before.

I think one of the other things is that they're going to kick out the founders and bring in a new CEO, for example. And that can happen and I think you need to have a dialogue and have a frank discussion about what the relationship is going to be. And if and when that happens, how that will play out and what the

founders' arrangement at that point might be? Are they leaving the company? Are they a consultant? What happens to their shares?

All that is subject to negotiation but you want to have that upfront dialogue. That's probably the biggest one. I think founders are petrified that they'll be kicked out of the company.

Dave Lavinsky: That's a good point. As you're saying that can and should be negotiated at the time of the financing so there are no surprises?

Brette Simon: Yeah that's right. If things go sour you're not really going to have the ability to control the situation at that point. The venture capitalists aren't stupid. They're going to have the right to get rid of you, but you can protect yourself with severance and make sure you can keep your shares. Or if they're bought back, they're bought back at a valuation that you're comfortable with.

Part of that again, it depends on are you being terminated for cause, without cause, are you quitting? A lot of that depends on the reason behind the termination but you certainly can have an employment agreement that says I'm going to be employed by the company for two years, three years, four years what have you. And if you terminate me early I'm protected in some measure. You can kind of flush out based on what they're willing to sign up to. You can get a sense of what their real plans are.

Dave Lavinsky: Got it. Any entrepreneur listening to this interview is going to listen to what you're saying and this is so natural to you because you do this every day, roll off things like anti-dilution and redemption.

It's going to be clear after thirty seconds that I need an attorney because there are so many issues to be negotiated, to understand. However there's always that chicken and egg issue where I can't afford an attorney. That's why I'm looking for capital.

The question is what is the right time for the entrepreneur or the management company to hire legal counsel during the process of raising capital?

Brette Simon: Yeah I hear you and it is tough. Ideally at the very early stages, as I talked about some of the things companies can do wrong, it would have been nice to have a lawyer there at the beginning with the intellectual property assignment agreements, or with issuing shares to people in violation of the securities laws.

People tend to just go off and do their things and don't have lawyers at that stage. I tell people, "*Call me, bring me in when you look like you have some interest and some term sheets coming in*." Then you have a viable financing opportunity. Otherwise it's a little too early stage and I don't want companies running up legal bills they can't pay. But if you're getting term sheets from some reputable groups or angel investors, then there's a decent likelihood that you're going to have financing.

We'll be able to pay for the legal fees. You don't want to sign a term sheet without having a lawyer look at it because there are too many "gotchas" in there. The funny thing is term sheets are not generally binding. Most provisions are nonbinding but they take on psychological significance. You always hear during a negotiation, "*Well that wasn't in the term sheet*" or "*We put that in the term sheet*." Even though it wasn't binding it doesn't matter. Everybody sort of refers back to that as the gospel.

You don't want to end up in a situation where you agreed to some zany tax structure or you agreed to really egregious liquidation preference and coupons and redemption provisions, and they can veto anything and everything you do in life and it's too late.

Usually that term sheet locks you up for a period of ninety days so you're sort of off the market. If it turns out you don't like the group, you can't really go run around and do anything for a couple of months. I'd say when term sheets are starting to come in the door is the best time if you haven't gotten someone involved before then that's the time.

Dave Lavinsky: That makes a lot of sense. You just alluded to the ninety day lockup. Can you talk about that a little bit more?

Brette Simon: Sure. So, any term sheet will generally [have one] – and the time period ranges from anywhere from sixty to ninety to one twenty, maybe forty-five being the shortest.

But generally speaking, once you sign a term sheet it basically says you're going exclusive with this group and you can't be talking to other parties, other potential investors. You can't be soliciting their input. You can't be negotiating with them. You can't be interacting with them in any way.

It's a pretty typical exclusivity provision in the agreement. That's why you have to be comfortable that this is the right group that you want to walk down the aisle with, because you've taken yourself off the market for a good couple of months. Even if the deal dies, and it runs out it didn't work out, that exclusivity provision and that term carry until it expires.

Even if two weeks in you realize gosh it wasn't the right fit, unless the venture capitalist is willing to waive that provision you're locked up and can't really do anything for that two, three or four month period.

Dave Lavinsky: Now how does that work if there's a lead investor and a syndicate of three or four other venture capital firms? How does that work? Is the term sheet a group term sheet? Or is this done with the lead and the lead helps create the syndicate so you are allowed to talk tot hem in the process?

Brette Simon: Both. Certainly if they're creating a group you're allowed to talk to them and it won't be an issue. It's meant to protect the VC, the lead, so it's up to them to waive that provision.

But a lot of times if they've already figured out who the group is going to be all those venture capitalists sign the term sheet together so you know who your investor group is. But if you're signing up with a lead and they're going to go and seek other members of the syndicate, then you'll certainly be allowed to dialogue with them.

Dave Lavinsky: Got it. And can you confirm that when you are dealing with one round of capital with multiple investors, that the terms are the same throughout? Is that correct? There's no difference between you and the lead investor, you and another investor. It's one set of terms that dictates for everyone in the round.

Brette Simon: Yeah, that's generally the case. Generally they're all going to buy the same security, Series A, B, C. The only time you'll see delineations is who sits on the board. So, if one group is behind the bulk of that series and one group is buying a very small amount they might not get a board seat.

The protective provisions may not kick in the same way. If it says to do this material transaction you need a majority or two thirds of the series and one group owns the bulk of that series the other group isn't really getting much protection. Actually they can end up with a veto right though because if the other group has almost enough but not enough and they need to go to that other group to get approval hey can end up actually having a lot of power.

Sometimes you'll see beyond sort of a two thirds or majority x group has to approve this right. If that group is a small group, not taking a big part of the round they may not get that special right to approve certain things.

Dave Lavinsky: Brette, one final question for you.

Brette Simon: Sure.

Dave Lavinsky: Is there anything else that our listeners should know about the legal issues related to raising capital that I forgot to ask you?

Brette Simon: I think we've covered most of them because the biggest issues tend to be negotiating the term sheet, intellectual property protection and then security laws violations. We pretty much covered the main areas that cause problems that I've seen in deals. I think we're in pretty good shape.

Dave Lavinsky: Excellent. Everyone once again, Brette Simon from Jones Day. Brette that was wonderful. I appreciate that you covered some critical points that every entrepreneur needs to know about when raising venture capital. Thank you again so much for your time.