**Emerging Growth Companies and Venture Capital Financing: Principles and Practice**

Professors Levy and Yaghmaie

Syllabus

(Subject to revision)

Fall 2013

Mondays, 8am to 10am

**Course Description and Materials**

The start-up high technology enterprise, privately financed largely with funds provided by angel investors and venture capital firms, is a successful source of important new and technologically innovative products. Many highly visible and successful companies have raised venture capital at some point in their life cycle. This course covers the legal and business issues that arise in the context of representing emerging growth companies and the venture capital investors who provide an important source of capital to such companies. In particular, the course will focus on the legal issues typically encountered by private companies at formation, financing, operation and key corporate events, including acquisition transactions and public offerings. Topics covered will include corporate formation and governance, angel investments (both equity and debt), venture capital financing, employment and equity compensation matters, protection of intellectual property, securities laws compliance and exit strategies through merger, acquisition or initial public offering. The course will offer an introduction to these topics through the eyes of attorneys who practice in a leading Silicon Valley-based law firm active in New York City's technology market and may also include guest presentations by industry participants, such as venture capitalists, angel investors and entrepreneurs.

**Reading**

The Entrepreneur's Guide to Business Law, 4th Edition (Bagley, Dauchy) (“**The** **Entrepreneur’s Guide**”)

Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist (Brad Feld, Jason Mendelson) (“**Venture Deals**”)

AVC – Fred Wilson’s Blog

**Grading**

The final grade will be based (i) 80% on a classroom exam (which may be replaced by a take home exam), and (ii) 20% on in-class participation as described below (including, prepared ques­tions/responses for two classes of your choosing). This seminar is subject to the Law School’s grading curve.

*Class Participation*. Class participation will comprise 20% of the final grade. Among the factors to be taken into account will be your comments, analyses, and insights during our in-class dis­cus­sion. Except in extra­ordinary circumstances, you will be expected to be prepared to partici­pate in each class session. Please let me know if you are unable to participate on a particular day due to employ­ment interviews, religious holidays, or emergencies.

**E-mail Communications**

E-mail communications can provide an important means of enhancing the learning process, but they should not become a substitute for analyzing a problem on your own. A student who e-mails a question to me is expected to have carefully considered the analysis on his or her own (or with a group of colleagues). If the question still remains unanswered, you are encouraged to raise it with me by e-mail or in person.

**Office Hours**

Professors Levy or Yaghmaie do not expect to hold fixed office hours. Students should feel free to email Professors Levy or Yaghmaie directly to schedule meeting during the semester.

**Contact Details**

Professors Levy or Yaghmaie can be reached as follows:

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**Relevant Cases:**

See Schedule A

**Cast of Characters:**

Founders: “Founder1” and “Founder2”

Early Employees: “CTO” and “VP”

Angels: “Angels”

Early VC: “EarlyVC”

Late VC: “LateVC”

**Class Description:**

| **Class** | **Date** | **Topic** | **Description** | **Reading Materials (In Advance)** |
| --- | --- | --- | --- | --- |
|  | September 2 | Introduction | * Overview of course
* Who are the players/stakeholders
	+ Founders
	+ Startup company
	+ Angel Investors
	+ Early Stage Venture Funds
	+ Late Stage Venture Funds
	+ Startup Employees
* Role of the Start-up/VC Lawyer
 | *Venture Deals*: Chapter 1 – The Players*The Entrepreneur’s Guide:* Chapter 3 – Soliciting and Working with an Attorney |
|  | September 9 | Incorporation | * Choice of Entity
* Why Delaware?
* Certificate of Incorporation
* Bylaws
* Directors
* Officers
* Founder Equity Split
* Issuance of Common Stock
	+ Consideration
	+ Vesting/Escrow of Unvested Founder Stock
	+ Right of First Refusal on Founder Stock
* Equity Incentive Plan
* Indemnification Agreement
 | *The Entrepreneur’s Guide:* Chapter 4 – Deciding Whether to Incorporate; Chapter 5 – Structuring the Ownership (except Tax Treatment of Founders’ Stock and Employee Stock Options) |
|  | September 16 | Seed Funding | * Who to raise from
* Structure: Preferred Stock vs Convertible Notes
 | Term Sheet: Seed PreferredTerm Sheet: Convertible Notes |
|  | September 23 | Themes: IP Protection, Employment, Equity Incentives | * Intellectual Property Protection
	+ Patents
	+ Copyrights
	+ Trademarks
	+ Trade Secrets
* Employment
	+ Employees vs Independent Contractor
	+ At-Will vs Term
	+ Proprietary Information and Invention Assignment Agreement
		- Assignment of IP (scope)
		- Non-solicitation
		- Non-competition
* Equity Incentives
	+ Options vs Stock
	+ NSO vs ISO
	+ Vesting (acceleration provisions)
 | *Venture Deals*: Chapter 1*The Entrepreneur’s Guide:* Chapter 5 – Structuring the Ownership (only Tax Treatment of Founders’ Stock and Employee Stock Options); Chapter 8 – Marshaling Human Resources; Chapter 14 – Intellectual Property and Cyberlaw |
|  | September 30 | Series A Financing: Part I | * Venture Capital Term Sheet
* Venture Math
 | *Venture Deals*: Chapters 3, 4, 5 and 6*The Entrepreneur’s Guide:* Chapter 13 – Venture Capital (pp 458-473)NVCA Form of Term Sheet |
|  | October 7 | Series A Financing: Part II | * Due Diligence
* Series A Preferred Stock Purchase Agreement & Disclosure Schedules
	+ “Knowledge”
	+ “Materiality” versus “Material Adverse Effect”
	+ Closing Conditions
* Legal Opinion
 | *The Entrepreneur’s Guide:* Chapter 7 – Raising Money and Securities Regulation;Due Diligence Request ListNVCA Form of Stock Purchase Agreement |
|  | October 21 | Series A Financing: Part III | * Amended and Restated Certificate of Incorporation
	+ Dividends
	+ Liquidation Preference (participating vs non-participating)
	+ Board rights
	+ Veto Rights
	+ Conversion (optional/mandatory)
	+ Conversion Price Adjustment (weighted average/dividends/special adjustments)
	+ Pay to play
	+ Redemption Rights
 | *The Entrepreneur’s Guide:*  Chapter 13 – Venture Capital (pp 473-491)NVCA Form of Charter |
|  | October 28 | Series A Financing: Part IV | * Investor Rights Agreement
	+ Registration rights
	+ Preemptive Rights
	+ Covenants
* Voting Agreement
	+ Board composition
	+ Drag along (Travos Case)
* Right of First Refusal & Co-Sale
 | *The Entrepreneur’s Guide:*  Chapter 13 – Venture Capital (pp 491-515)NVCA Form of Investor Rights AgreementNVCA Form of Voting AgreementNVCA Form of Right of First Refusal & Co-Sale Agreement |
|  | November 4 | **Exercise: Term Sheet Negotiation** | * 2 teams: Company and VCs
 | *Venture Deals*: Chapters 9 and 11 |
|  | November 11 | Distressed Situations & Down Rounds | * Transaction
* Approving the transaction (DGCL 144; Board Common Law Fiduciary Duties); Business Judgment Rule
* Risk mitigation
	+ Seeking alternative funding sources
	+ Adequate disclosure to stockholders
	+ Rights offering
 | Article: “Finding Safe Harbor: Clarifying the Limited Application of Section 144” by Blake Rohrbacher et al.   |
|  | November 18 | **Panel: NY Venture Capitalist & Founder of Recently Funded NY Start-up** | * Considerations in sourcing a deal and selecting a VC
* Pricing and structuring deal
 |  |
|  | November 25 | Exit: Part I | M&A | *The Entrepreneur’s Guide:*  Chapter 16 – Buying and Selling a BusinessM&A LOI |
|  | December 2 | Exit: Part II | IPO | *The Entrepreneur’s Guide:*  Chapter 17 – Going PublicCooley IPO Handbook |

**Post Course Reading (Optional)**

- General Practice Tips for New Lawyers

**Schedule A - Relevant Cases**

| **Name** | **Citation** | **NVCA Ref** | **Lexis Summary** |
| --- | --- | --- | --- |
| FGC Holdings Ltd. v. Teltronics, Inc. | Case No. C.A. 883-N (Del. Ch. Ct. 9/14/05) | NVCA Charter | When the special series of preferred stock was created, one seat on the board was designated as to be elected by that class. The corporate charter limited the number of directors to five, apparently in an effort to avoid dilution of the preferred stockholder interest. When a previous stockholder had held the preferred stock, it had not exercised its designation right, so the common stockholders elected all the directors, and the corporation resisted returning to its former practice when, after five directors had been named, the new preferred stockholder tried to designate a director. The court construed the charter and the CD together, and held that to give effect to both provisions, five directors were always authorized, of which the preferred stockholder could designate one, if it wished. The mere failure to designate such a director for several years did not clearly manifest an intent to waive operation of the provision. Since ordering immediate seating of a sixth director would have caused a charter violation, and since the next annual meeting was only six weeks away, the court simply directed that a designated director be named and seated thereafter. |
| Benchmark Capital Partners IV, L.P. v. Vague | Case No. C.A. 19719 (Del. Ch. Ct. 7/15/02) | NVCA Charter | The junior stockholder invested in the first two series of the corporation's preferred stock. When additional capital was required, the preferred stockholder was an able and somewhat willing investor. As a result of that investment, the junior stockholder's holdings were relegated to the status of junior preferred stock, and the senior stockholder acquired a controlling interest in the corporation by virtue of ownership of senior preferred stock. The certificate of incorporation granted the junior preferred stockholders a series vote on corporate actions that would materially adversely change the rights, preferences, and privileges of the series of junior preferred stock. In addition, the junior preferred stockholders were entitled to a class vote before the corporation could authorize or issue, or obligate itself to issue, any other equity security senior to, or on a parity with, the junior preferred stock. The junior stockholder could not show a reasonable probability of success on the merits, irreparable harm if the injunction was not granted, or a balance of equities in favor of granting the relief. |
| Fletcher Int’l, Ltd. v. ION Geophysical Corp. | Case No. C.A. 5109-VCP (Del. Ch. Ct. 5/28/10) | NVCA Charter | The PSH was the sole holder of all outstanding shares of corporate preferred stock, and pursuant thereto, it had the right to consent to the corporation's issuance of any securities through its subsidiaries. The corporation issued two CPNs to an anticipated joint venturer, including one through its subsidiary. A provision thereof provided for the conversion into shares of common stock of the corporation. The PSH filed suit and thereafter sought partial summary judgment. The court previously denied relief with respect to the invalidation of the issuance of the CPN or the requirement for the corporation to repay funds borrowed under the CPN. As to unresolved issues involving breach of contract and fiduciary duty claims, the court held that the PSH had a contractual right to consent to the issuance of any security by the corporate subsidiary. The court concluded that the CPN was a security of the subsidiary. Accordingly, the corporation violated the terms that governed the PSH's stock by issuing the CPN without the PSH's consent. As claims against the board of directors sought to remedy the same conduct complained of in the breach of contract claim, they were superfluous. |
| In re Appraisal of Metromedia International Group, Inc. | Case No. C.A. 3351-CC (Del. Ch. Ct. 4/16/09) | NVCA Charter | The litigation arose from the merger of a company with the corporation, in which the corporation was the surviving entity. The corporation asserted that the highest value of the preferred stock shares was based on the preferred stock being converted into common stock shares under the certificate of designation. In contrast, the stockholders relied upon three different valuation approaches, pursuant to the statutory appraisal rights of Del. Code Ann. tit. 8, § 262. The court found that the corporation's certificate of designation delimited the value to which the preferred stockholders were entitled in the event of a merger. Because the certificate fixed the precise value to be paid to the preferred stockholders upon a merger event, the sole right available to the preferred stockholders under the certificate was the non-consensual conversion procedure under that provision of the certificate. Although the court considered the expert witness opinions, the court concluded that the provisions of the certificate of designation fixed the value of the preferred shares on the merger date. The stockholders were entitled to interest under Del. Code Ann. tit. 8, § 262(h). |
| SV Investment Partners, LLC v. Thoughtworks, Inc. | Case No. C.A. 2724 (Del. Ch. Ct. 11/10/10) | NVCA Charter | The CI granted preferred shareholders the right to redeem their stock for cash out of "any funds legally available therefor." Plaintiffs argued that "funds legally available" meant "surplus," and presented an expert who opined that defendant had a surplus sufficient to redeem all the preferred stock. The court held that "funds legally available" was not equivalent to "surplus," but meant cash that was "available" (cash on hand or readily accessible through sales or borrowing) and that could be deployed "legally" for redemptions without violating Del. Code Ann. tit. 8, § 160 or other statutory or common law restrictions, including the requirement that the corporation be able to continue as a going concern and not be rendered insolvent by the distribution. Plaintiffs failed to prove that defendant's board of directors (i) acted in bad faith in determining whether defendant had legally available funds, (ii) relied on methods and data that were unreliable, or (iii) made determinations so far off the mark as to constitute actual or constructive fraud. In making its redemption decisions, the board acted in good faith and relied on detailed analyses developed by well-qualified experts. |
| Kumar v. Racing Corp. of Am., Inc. | Case No. C.A. 12039 (Del. Ch. Ct. 4/26/91) | NVCA Charter | After steps were taken to consummate a cash out merger of defendant corporation by its majority stockholder, plaintiff corporate owners sought and obtained a temporary restraining order that enjoined defendant from effectuating the merger. Defendant challenged the order. On appeal, plaintiff asserted that the merger was not entirely fair, that the directors' decision to approve the merger was made without due care, and that the merger violated the terms of the restated certificate. The court held that plaintiffs established a reasonable likelihood of success on the merits as to their entire fairness claims due to the timing of the merger, as well as the structure, negotiation, and disclosure of the merger. The court also held that plaintiffs were likely to prevail on their claim that defendants breached their duty of care because the only disinterested director was not only uninformed, but intentionally misled. The court held that plaintiffs did not establish a violation of the restated certificate. As to plaintiffs' harm, the court held that injunctive relief was appropriate notwithstanding the limited showing of irreparable harm. The court denied certain mandatory relief. |
| Lidow v. Superior Court | 141 Cal. Rptr. 3d 729 (Cal. Ct. App. 2012) | NVCA Charter | The corporation was a Delaware corporation. The officer left his position pursuant to a negotiated separation agreement following an internal investigation of accounting irregularities. He alleged that the governing board had removed him in retaliation for his complaints about possible illegal or harmful activity and breaches of ethical conduct relating to the investigation. The corporation's bylaws provided that officers served at the pleasure of the board and could be removed with or without cause at any time. The court concluded that the superior court erred in applying Delaware law pursuant to the internal affairs doctrine. Although removing an officer might fall within the scope of a corporation's internal governance for purposes of applying the law of the state of incorporation under other circumstances, the internal affairs doctrine did not apply when an officer asserted a claim for wrongful termination in violation of public policy. The termination of a corporate officer for reasons that allegedly violated public policy did not fall within the scope of a corporation's internal affairs because such claims involved a vital interest protected by California law. |
| VantagePoint Venture Partners 1996 v. Examen, Inc. |  871 A.2d 1108 | NVCA Charter | The shareholder was a Delaware limited partnership and was a Series A preferred shareholder of the corporation. The corporation was a Delaware corporation engaged in the business of providing web-based legal expense management solutions, and, following the merger with the legal services corporation, also a Delaware corporation, a combined name became the surviving entity. The corporation sought a judicial declaration that, pursuant to controlling law, the shareholder was not entitled to a class vote of the Series A preferred stock on the proposed merger between the corporation and the legal services corporation. If Delaware law applied, the shareholder did not have a class vote and would have been permitted to block the vote approving the merger. The trial court held that Delaware law governed the vote that was required to approve the merger between the two Delaware corporate entities. The court held that the trial court properly applied the internal affairs doctrine of Delaware as it applied to foreign corporations and properly held that the shareholder had no class vote. |
| Wilson v. Louisiana-Pacific Resources, Inc.  | 138 Cal. App. 3d 216 (1983) | NVCA Charter | Plaintiff shareholder brought an action against defendant Utah corporation, seeking a declaratory judgment that defendant met the tests of Cal. Corp. Code § 2115, and that he was therefore entitled to cumulative voting in accordance with Cal. Corp. Code § 708. The trial court entered a judgment for plaintiff and defendant appealed on constitutional grounds. The court affirmed the judgment, concluding that the choice of California law, rather than Utah law, did not exceed federal constitutional requirements. In determining whether a state's choice-of-law decision exceeded federal constitutional requirements, the court considered whether California had significant contact or a significant aggregation of contacts, creating state interests, such that the choice of its law was neither arbitrary nor fundamentally unfair. The court explained that the test was met because, to be subject to § 2115, defendant was required to have a significant aggregation of contacts and the state interests created by those contacts were substantial. |
| in re Trados Inc. S’holder Litigation | Case No. C.A. 1512-CC (Del. Ch. Ct. 7/24/09) | Voting | When the corporation became a subsidiary of the PC, the preferred stockholders (PSs) received some of the PC's contribution through the triggering of a liquidation preference, and the remainder was paid to the executive officers of the corporation pursuant to a bonus plan. However, the common stockholders received nothing for their common shares. The FS filed suit, alleging that the corporate board favored the interests of the PSs and that the PC and some of its officers conspired with certain corporate directors to defer revenue until after the merger. The court initially noted that the claims were not barred by laches. The FS successfully rebutted the presumption of the business judgment rule pursuant to Del. Code Ann. tit. 8, § 141(a) for purposes of surviving the dismissal motion. She showed that the interests of the PSs and the common stockholders were not aligned. The directors owned preferred stock and had relationships with PSs, such that they were either interested or lacked independence with respect to the merger decision. However, the FS did not sufficiently allege a claim based on the alleged revenue manipulation, as it required the court to make unnecessary inferences. |
| Abry Partners V v. F&W Acquisition LLC | Case No. C.A. 1756-N (Del Ch. Ct. 2/14/06) | Voting | The parties entered into the SPA for the buyer's purchase of a portfolio company. The SPA indicated that the buyer only relied on representations and warranties within the four corners, it limited the liability of the seller for any misrepresentation of fact contained therein, and it provided that an indemnity claim was the buyer's exclusive remedy. Thereafter, the buyer filed suit, alleging that the financial statements contained material misrepresentations, resulting in excessive overpayment. The seller sought dismissal based on failure to state a claim. The court initially noted that due to the forum selection clause and the choice of law principles of Del. Code Ann. tit. 6, § 2708, Delaware law was controlling. Further, the complaint was pled with sufficient particularity pursuant to Del. Ch. Ct. R. 9(b). The court found that as the parties were sophisticated, the exclusive remedy provision was enforceable to the extent that the seller did not make intentional misrepresentations or act with knowledge of the falsity thereof. However, if the buyer showed knowledge or intentional misrepresentations, then the limitation provision was invalid as against public policy. |
| Delaware Coalition for Open Government v. Strine  | (D. Del. Aug. 30, 2012) | Voting | The First Amendment protects a qualified right of access to criminal and civil trials. Except in limited circumstances, those proceedings cannot be closed to the public. Under the Delaware law and Chancery Court rules, a sitting judge of the Chancery Court, acting pursuant to state authority, hears evidence, finds facts, and issues an enforceable order dictating the obligations of the parties. The Court concludes that the Delaware proceeding functions essentially as a non-jury trial before a Chancery Court judge. Because it is a civil trial, there is a qualified right of access and this proceeding must be open to the public. |