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The 15-Minute Founder's Guide: Series A Financing Documents

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INTRODUCTION

Heading into a startup equity financing, especially the company's first, every founder or member of the management team owes it to their stakeholders, their company and themselves to have at least a working knowledge of the nature of the deal they're leading their company through. However, financing documents are esoteric, densely written and most often have nothing to do with the nature of the company's business or anything else the founders' find remotely interesting.

Nonetheless, many founders excel at this process to the benefit of their teams and their professional missions by leveraging a foundational familiarity with the important aspects of the equity financing. To that end, nearly every financing that we help our clients through begins with a 60-90 minute, clause-by-clause refresher to bolster the founder's ability to fruitfully contribute to a positive outcome for the company. Equity financings, whether they be Series Seed or Series E, in all likelihood are among most consequential transactions in founders' lives, so founders should demand this level of support and transparency from their entire team, including legal.

This 15-Minute Founders' Guide to Series A Transaction Documents is meant to equip founders with a functional orientation in the terms most frequently seen in "Silicon Valley style" Series A documents and to highlight important and frequently negotiated concepts for founders. Whether founders read this upon incorporating their new company or amid the flurry of activity leading up to an equity financing, this guide aims to help founders more effectively lead their companies up to and through equity fundraisings.

The following sections break down the "core five" customary startup equity financing documents, in the same order that we talk through them with the companies we work with, i.e., reverse order of complexity. This way, the documents start out digestible and by the time we cover the more complex topics, founders have already developed an orientation in the documents.

THE "CORE FIVE" VENTURE DEAL DOCUMENTS

a. The Voting Agreement

The Voting Agreement primarily serves two very straightforward, yet extremely important, functions: (1) specifying who serves on the board and who is entitled to decide how the board may change over time; and (2) ensuring that an eventual sale of the

company (if any) happens in an orderly fashion. The common theme among these two distinct concepts is that they both require the stockholders (the founders and the investors) to vote their shares in a specified manner (in the context of board elections or a sale of the company), hence "the Voting Agreement."

i. Board Composition

In category (1) — the composition of the board — an important background fact is that a corporation's board is, by law, electec by the corporation's stockholders in a democratic, majoritarian fashion. The Voting Agreement helps companies avoid the politics, expense and uncertainty of administering that democracy by contractually obligating the stockholders (typically anyone holding 1% or more of the company's stock) to vote their shares as designated by certain specified parties who are highly aligned with the company's long-term success. Rights to designate board members are commonly referred to as "board designation rights."

For example, Series A Voting Agreements frequently require all stockholders to vote their shares in favor of two board members "designated" by the founder(s) and one board member "designated" by the lead Series A investor. As the company progresses through fundraising rounds, the number of board members designated by investors and the number of board seats reserved for "independent" directors (industry experts who are otherwise unaffiliated with the company — these are typically designated by the other members of the board), both typically increase, thereby tilting the power over board actions away from the founders over time.

In thinking about the Voting Agreement, it's important for founders to keep in mind that the board effectively controls every material decision the company makes [e.g., hiring and firing the CEO, material commercial deals and partnerships, future fundraising events, annual budgets, compensation (including equity awards), and exit transactions] and that it's very rare for founders (who typically are the board room representatives of the entire team of employees) to regain power on the board over time. Therefore, almost every venture round has the board composition negotiated specifically in the term sheet as a foundational element to the deal.

The Voting Agreement also gives designating parties the ability to swap out their representatives on the board by delivering a notice to the company, following which, the stockholders are contractually obligated to formally elect the new designee to the board. Again, this furthers all stakeholders' interests in orderly, predictable governance at the board level.

ii. The "Drag-Along"

Despite the negative images that the phrase "drag-along" might bring to mind, this provision is included in nearly every Voting Agreement because it serves the stakeholders' general interest in maximizing the value the company can garner in a sale transaction.

The premise here is legal: stockholders who do not vote in favor of a sale transaction generally retain "appraisal rights" and "dissenter's rights" to sue the company (or its board) to challenge the transaction, e.g., for not getting the best value for stockholders in the sale transaction. The risk of shareholder lawsuits following the sale inherently drives down the value acquirors are willing to pay for the company, since the acquiror will have to pay to defend against or settle those lawsuits after closing.

Therefore, the Voting Agreement's "drag-along" provision contractually obligates stockholders (typically anyone holding 1% or more of the company's stock) to vote in favor of approved sale transactions, thereby reducing litigation risk of the sale and increasing the value acquirors are willing to pay for the company.

This structure puts tremendous importance on the issue of how the "drag-along" gets triggered (i.e., the issue of what is an approved sale). A well-drafted and fair "drag along" provision will ensure that majorities of each key constituency independently support the sale before the "drag along" is triggered. For example, most Series A "drag along" provisions require support from (a) the board; (b) a majority of the founders (or the subset of the founders who are still working for the company at the time of the sale); and (c) a majority of the investors. This ensures that majorities of each stakeholder constituency believe the deal is "fair"

and, as a corollary, that stakeholders can feel comfortable that they won't be "dragged" into supporting a sale transaction that isn't supported by similarly situated stakeholders.

To further ensure fairness, to all parties, the Voting Agreement will spell out several conditions to any "drag along" transaction. To name a few examples: (a) all similarly situated stakeholders should receive the same form of consideration, (b) stakeholders must not have liability beyond the proceeds they'll receive from the deal, and (c) stakeholders can't be forced to enter into any non-competes or break off any other commercial arrangements in order to receive their sale payout.

b. The Right of First Refusal and Co-Sale Agreement

The purpose of the Right of First Refusal and Co-Sale Agreement (or ROFR/Co-Sale Agreement for short) is simply to implement roadblocks to founders liquidating their shares in the company and for the company and investors to keep control of the capitalization table. The premise here is that investors expect to have the first opportunity at liquidity (ahead of founders) and that the company is more valuable to all stakeholders if it has a stable capitalization structure (where everyone has pre-agreed on the founders' economic and voting interest in the company).

The ROFR/Co-Sale Agreement accomplishes this goal by requiring founders (typically any member of management holding at least 1% of the company's stock) to navigate a complex and time-consuming process before they're permitted to transfer shares to third parties.

The process is laid out in brief below, but the key takeaway is that the smoothest (and often only) viable route for founders to liquidate shares before an exit is by a full waiver of the ROFR with the consent of the investor group (one of many reasons why it pays to practice good investor relations at all times).

Most ROFRs provide that, if a founder wishes to transfer shares to a third party, the founder is required to present the third party's bona fide offer to buy the shares (including the material terms of the proposed transfer) to the company and the investor group, who each have sequential periods during which to elect to buy the shares (instead of the third-party buyer) on the same proposed terms (cutting back what the third-party buyer is able to eventually buy — this is the "ROFR Right"). If any shares remain available for sale to the third party, the investors then have the "right of co-sale" to sell shares to the third-party alongside the founder (thus cutting back the number of shares the founder has the right to sell).

If you struggle to imagine a third party submitting a bona fide offer to buy a substantial amount of highly speculative and illiquid shares (which might be cut back to zero based on the company or the investors invoking ROFR rights) from a founder (or partially from investors who invoke their co-sale rights), and where the offer to buy has to remain open 45-60 days (long enough for the ROFR/Co-Sale notice and election periods to run), that's the idea. The chilling effect on founder transfers is precisely the intended effect of the ROFR/Co-Sale Agreement.

Therefore, when founders aim to sell shares (beyond the "permitted transfers" described in the next paragraph), the typical process would be to socialize this with the company's large investors, and if the investors are amenable, they agree to waive applicability of the entire ROFR/Co-Sale Agreement with respect to the pre-approved founder transfer, thereby avoiding all of the process in the ROFR/Co-Sale Agreement.

While the majority of the ROFR/Co-Sale is not typically negotiated heavily, if at all, one area deserves the founders' attention: the list of "permitted transfers." Each ROFR/Co-Sale Agreement will have a list of categories of permitted founder transfers, including transfers to family trusts for estate planning purposes (which is almost always freely permitted), transfers of a de minimis amount of the founder's shares (typically negotiated to be anywhere from 0-5% of the founder's shares) and pledging shares to a lending institution as collateral for a loan.

Many successful companies take several years to reach an exit, so the "permitted transfers" set forth in the ROFR/Co-Sale Agreement can be extremely important to help founders avoid becoming "paper billionaires" who don't have access to cash for life's needs. However, in upside scenarios like these, investors are often amenable to facilitating, e.g., through providing waivers

or purchasing founders' shares directly, liquidity for founders and potentially others on the team.

Interestingly, the ROFR/Co-Sale Agreement highlights a divergence in the interests of the founders (who would individually benefit from having more freely transferrable shares) and "the company" (which benefits from stability in the capitalization table and from having founders remain incentivized to maximize share value). This is one of a few instances where "the company's" interest align more with the investor group than the founders. A discussion with your lawyer (who most likely represents "the company") will help ensure that the company and the founders' interests are accounted for appropriately.

c. The Investor's Rights Agreement

Though investors have rights under the Voting Agreement and the ROFR/Co-Sale Agreement, the Investors' Rights Agreement (or IRA for short) contains a further set of the company's ongoing obligations to the investors in the following areas (a) investor access to liquidity in the public markets, known as "Registration Rights"; (b) investor rights to receive periodic informational updates from the company and to make further investments in the company, and (c) additional covenants about how the company can operate going forward.

i. Registration Rights

Though these rights are less commonly invoked, almost every IRA will include many pages of a mostly standard set of "Registration Rights," which spell out under which circumstances investors may demand the company register the investors' shares with the SEC (making them freely tradeable on public markets) through an IPO, a follow-on offering or otherwise.

Though Registration Rights are densely written and highly complex (as with all things relating to SEC requirements for registering securities), they are (thankfully) rarely heavily negotiated because of the practical reality that IPOs and other registrations of securities with the SEC generally wouldn't be successful without support from substantial majorities of all of the company's stakeholders (and even then, registrations are subject to many other risks). Therefore, most capital markets transactions have the stakeholders pursuing a process that's mutually agreed at the time, which may or may not be in line with what the IRA provides.

Nonetheless, the Registration Rights serve as an important backstop for investors in companies who have not provided liquidity opportunities for investors (e.g., an IPO or sale of the company) after several years. The threat of a registration demand under the IRA is enough to bring the company and the investors together to negotiate an alternative outcome (e.g. a sale of the company or, if the company is profitable, an investor buyout program).

If founders sense that investors aim to heavily negotiate Registration Rights, it may mean that the investors are inexperienced and/or overly aggressive.

ii. Information and Pro Rata Rights

Most IRAs spell out special rights, typically "Information Rights" and a "Right of First Offer," for "Major Investors" who have invested above a certain threshold. The threshold may tie to a number of shares or an amount invested, but in either case, founders should pay close attention to who qualifies for these important rights, as these can affect the trajectory of the company's fundraising efforts going forward.

Information Rights typically entail the right to receive periodic financial statements, annual budgets and capitalization table information as well as the right to visit the company's premises to inspect books and records. The best outcomes for information rights occur where the company's reporting obligations to investors align with its own corporate hygiene efforts. For example, audited financial statements can be expensive and time consuming to prepare (especially if they're deliverable in Q1 of each year), so companies should avoid the obligation to deliver audited financials until they understand the rigors of the process and would otherwise be undertaking those efforts for their own purposes.

The "Right of First Offer" (used interchangeably with "pro rata rights," "preemptive rights" or sometimes "ROFR rights"), refers to

the Major Investors' right to be notified of and participate in future fundraises. While the spirit of the pro rata rights are almost always respected (in that companies do provide Major Investors the opportunity to invest in subsequent rounds), technical compliance with the pro rata rights is often burdensome (including waiting 20 days following notice to the Major Investors before the initial close of the new round). For this reason, Major Investors and companies typically align ahead of time regarding the terms and allocations in the new round. Then, once all parties have aligned on a path forward, the Major Investors waive the company's obligations to comply with the strict letter of the Right of First Offer. Founders can add this to the list of reasons why it pays to foster a trusting, collaborative relationship with their investors.

iii. Additional Covenants

The IRA also covers a slate of miscellaneous obligations on the company to run the business according to a generally accepted set of best practices for startup companies including (a) maintaining appropriate insurance policies; (b) requiring that all new employees sign IP assignment agreements and receive equity with standard vesting; (c) using reasonable efforts to maintain "Qualified Small Business Stock" status (which qualifies certain investors for tax-free treatment on up to $10m or more in qualifying gains on company equity); (d) holding regular board meetings; and (e) ensuring that the company abides by reasonable policies regarding workplace harassment, corruption, cybersecurity, regulatory compliance and the like.

In addition, and more importantly, lead investors will often include a list of operational decisions the company will be prohibited from making without the approval of the lead investor's board designee. Often called the "Preferred Director Approval Rights," this optional set of provisions is often an unexpectedly powerful source of investor influence over the company. For example, a preferred director may have approval rights over hiring, firing or changing the compensation of executives or over entering new lines of business, both of which are inherently part of any startup's operational roadmap. Therefore, a preferred director who has control over these activities has substantial control over the direction of the company, and founders should pause to understand the implications of these provisions very closely before agreeing to them.

d. Stock Purchase Agreement and Disclosure Schedule

The aptly named Stock Purchase Agreement (or SPA for short) is the transaction document responsible for the sale of preferred stock to the investors. The opening section will describe the price per share and amount of shares to be sold, all of which corresponds to a tabular schedule (typically Exhibit A) to the agreement that will be updated for each closing. This part is very straightforward and rarely negotiated.

From there, the SPA spells out (a) representations the company will make to the investors that describe the current state of the company, (b) representations the investors will make to the company that primarily serve to assure all parties that the sale will be conducted in compliance with securities laws, and (c) any conditions to closing, including the requirement that all transaction documents be executed by all parties as part of the closing.

i. Representations and Warranties

The bulk of the negotiations in the SPA invariably revolve around the representations and warranties (or "reps") that the investors require the company to make as a condition to closing. These reps cover a broad range of topics about the company including (a) basic corporate information (e.g. that the company was duly formed, remains in good standing, and doesn't require any third-party approvals to enter into the transaction that it hasn't already obtained, as well as a full statement of the company's outstanding share capitalization); (b) intellectual property matters (e.g. requesting a list of registered IP and domain names, a list of inbound or outbound material licenses, and confirmation that all founders have assigned relevant IP to the company); (c) commercial representations (e.g. requesting a list of key partnerships and material payables); (d) financial information (e.g. requesting recent financial statements and lists of any outstanding debt); and (e) other key facts about the company (e.g. that there are no outstanding lawsuits, and that the company has been in compliance with all applicable laws and otherwise has good corporate policies in place).

While most of these representations are standard, founders should consider whether they are comfortable making all of the

requested reps (as an omission or error in disclosing here can give rise to a claim that investors were misled into making their investment into the company). Some key areas for compromise here are (a) adding “knowledge qualifiers” (e.g. “To the company’s knowledge, it has not infringed on any third party’s intellectual property rights…”) and/or (b) adding “materiality qualifiers” (e.g. “The company has been in material compliance with all applicable employment laws…”). In this way, investors can get comfortable that the company rests on a firm foundation without requiring the company to conduct extensive patent searches or legal diligence exercises (of which the benefits sometimes do not justify the cost).

ii. The Disclosure Schedule

Each of the reps in an SPA will have a corresponding section in a separate document called the “Disclosure Schedule” or the “Schedule of Exceptions.” The company and company counsel will work together to populate the Disclosure Schedule with any known exceptions to the reps or any affirmatively requested information in the rep. For example, the SPA will have a rep that no founder has vesting acceleration rights, and the Disclosure Schedule will have a line item describing which founder(s) have such rights, with the implication that, other than as written into the Disclosure Schedule, no other team members have vesting acceleration rights.

In working with counsel to populate the Disclosure Schedule, founders should err on the side of over-disclosing. The premise here is that any matter disclosed to investors in the Disclosure Schedule protects the company from claims from investors that they were misled into investing.

Founders should pay extra attention to this work stream, as it can require substantial institutional effort to populate the Disclosure Schedule after reviewing corporate records and other operational documents (e.g. commercial agreements) that company counsel may not have knowledge of. Having organized corporate records and a dedicated management team member can avoid the need to pay lawyers (a lot) to do this work for the company.

e. The Certificate of Incorporation

Many of the terms contained in the Certificate of Incorporation (or Charter) are driven by or mirror statutes in the corporate code that pertain to shares and stockholders rights. Therefore, a number of the provisions are fairly boilerplate and rarely subject to negotiation (e.g. describing the nature of the different classes and series of shares and the processes for holding stockholder votes, conducting stock splits, providing shareholder notices, issuing dividends and distributing proceeds upon a liquidity event.)

Nonetheless, the Charter often represents a substantial portion of the drafting negotiations for the deal, as the Charter contains provisions pertaining to, among other things, (a) the board composition (including who is entitled to vote for which directors); (b) preferential rights to proceeds from liquidity events; (c) special voting rights (known as “Protective Provisions”) that require investor consent for an enumerated set of corporate actions; (d) anti-dilution rights (including how such rights are waived); (e) investors’ rights to convert into common stock (including the calculation for the conversion ratio and the circumstances in which conversion may occur voluntarily or involuntarily); and (f) indemnification of corporate officers and directors.

Of special importance are the Protective Provisions. Much like the Preferred Director Rights typically set forth in the IRA, the Protective Provisions require special approval of the investors (not just their representative on the board) in order for the company to take a certain set of actions. This typically includes actions required to raise a new round, effectively giving the current investors a veto right over the company raising additional capital. Founders should pay close attention to which investors are in control of these approvals (in light of how many votes are needed and the holdings of the various stakeholders) and work to maintain strong relationships with any stakeholder groups whose approval will be needed for foreseeable future actions.

Founders should also keep in mind that the Charter is not a contract, but instead is the constitutional document describing the company and its functions. In other words, any action putatively taken by the company that is not in compliance with the Charter may be null and void. Therefore founders should work with counsel to have a firm understanding of when the Charter calls for a special process in order to take a given corporate action (cleanup in this area can be costly and time intensive).

CONCLUSION

The “core five” equity financing documents summarized in this Founders’ Guide are cumulatively over 100 pages of mostly dense legalese. It is almost certainly not any founder’s highest and best use to fully master these documents line by line. Nonetheless, the optimal level of mastery is somewhere well north of “clueless,” and founders owe it to their companies to aim for that target. This means relying on outside counsel (who ideally have taken clients through this education process many times before) but also working separately to orient yourself in the terms of the deal. Hopefully this Founders’ Guide serves to aid in that effort with the result that you can communicate with and leverage outside legal counsel efficiently and eventually land on the best Series A deal for your startup.

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