Balancing
the
deal

The structure of a private stock offering can have dramatic economic consequences. Do you know enough to help your client company?

Pitfalls await the unsophisticated in the process of raising money through private placements. Guides for lawyers to securities and tax issues do exist. But what law books and statutes don't address is how to structure an investment that recognizes the legitimate competing needs of the company, the entrepreneur and the investor, and the consequences to each of them of the myriad forms of investment.

Depending on the structure of the security offered (and the initial valuation of the company), an investor can salvage an investment in a company that went sour or wind up with a mediocre investment in a company that met expectations.

What *are* the characteristics of certain debt and equity securities, and what are the goals and concerns of investors as well as different structures and provisions to achieve those goals? What are the economic impacts of alternative financial structures? Additionally, what "deal vocabulary" and contractual provisions does company counsel need to effectively structure a transaction?

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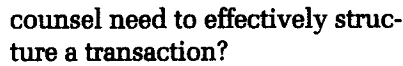

The first issue is the relative advantage to the company of selling debt or equity. Generally, companies prefer selling equity securities. Proceeds are recorded as equity on the company's balance sheet and, except as otherwise contractually agreed (i.e. "put" or "redemption" rights), become permanent capital that increases the company's net worth, borrowing capacity and overall financial strength. Because debt must be repaid, it is "temporary" capital and less valuable to a company. Debt does not increase net worth although it does expand the company's capital base.

Debt that is contractually subordinated to the company's bank loans may be considered by a bank to be "equity" for some purposes, including how much money it will lend and for calculating debt-to-net-worth tests. Trade creditors, however, regard subordinated debt as a liability rather than equity, unless the debt is specifically subordinated to the particular creditor.

Thus, for businesses like retailers that obtain a substantial percentage of their credit from suppliers (i.e. landlords and manufacturers) rather than banks, the company has a strong incentive to sell equity. Even if investors are subordinate to trade creditors, the company's difficulty in dealing with landlords and vendors is increased because subordination is hard to explain, and an additional document (the subordination agreement) must be created and executed.

Practicality and simplicity therefore militate in favor of equity investments in such businesses rather than subordinated debt. Ultimately, selling a security that maximizes the credit availability to the business benefits both the investor and the company.

Finally, there is a significant difference in the balance-sheet and income-statement consequences of dividends accumulated on equity compared to interest accrued on debt. Accumulated dividends represent a priority on prospective payments among stockholders and are generally disclosed only in footnotes to financial statements. Such dividends have no impact on the company's net worth until paid and do not reduce income. Interest that *accrues* on debt, however, negatively affects the income statement and balance sheet because the interest is booked as an expense, thereby reducing profit, increasing liabilities and decreasing net worth.

Investor goals and concerns

Liquidity. The first question any sophisticated investor deals with is the exit strategy — how is the investor going to cash out? The illiquid nature of private investments inherently increases an investor's risk. Unlike a public

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security, which the investor can convert to cash by selling at any time, private-company securities convert to cash only under limited circumstances. Consequently, investors need exit strategies that enable them to liquidate their investment within a reasonable time.

There are three practical ways to exit a private investment — the company can go public, be sold, or stockholders can purchase the investor's interest. To address these concerns, investors negotiate various provisions that increase their ability to cause, or benefit from, the three possible exits.

High rate of return. Investors in private placements are governed by normal investment concepts of a risk/reward ratio. The safest and most liquid investments (i.e., savings accounts) bear the lowest rates of return. The risk is minimal and so is the reward. Private placement risk is dramatically higher. For a risk/reward ratio to remain balanced, the potential reward in a private investment must exceed the reward in alternative investments.

The goal: a return of capital and a return on capital.

Institutional investors express this mathematically as a goal of achieving a compounded internal rate of return (IRR) of 30 percent to 45 percent — in exchange for one investment dollar today, the investor anticipates receiving in five years an amount between $4 (30 percent) to $6 (45 percent). The short time horizon reflects a goal of liquidity, as well as the reality that the longer an investment is held, the harder it is to achieve a high compounded rate of return.

Return of capital. The investor wants an investment that maximizes the probability of achieving a return *of* capital and a return *on* capital. The various components in the capital structure can be compared to the levels of a building. Debt is closest to the ground, has the least risk and lowest potential return, and is repaid first. Mezzanine financing is higher from the ground than debt, has greater risk than debt, and therefore has a greater potential return than debt. Farthest from the ground is equity, generally common stock, which has the highest potential return, and is the last capital to be paid.

Private placements are therefore generally structured as mezzanine financings (preferred stock, convertible debt or subordinated debt with equity features), whereby investors receive their capital back, as well as a return on their capital, before common stockholders receive any return.

For debt investments, the preferential return of and on capital is achieved automatically because the principal and interest on the debt must be repaid prior to distributions to any stockholders. To achieve a higher rate of investment return than simple repayment of principal and interest, debt may be convertible into common stock, or the debt holder may be given at a nominal price either common stock or warrants to purchase stock that the debtholder continues owning even after repayment of the debt. Proceeds from the sale of the equity (common stock) or equity equivalents (warrants) are intended to provide the investor with the above average rate of return being sought.

Control. Investors generally desire control of the board of directors, negotiated limits on levels of executive compensation, and the ability to block certain corporate transactions that may be desirable for the entrepreneur but undesirable for the investor. As an example of competing interests, re-investment of the company's cash flow may grow the business but simultaneously defer profits, defer the ability to sell the company or take it public by minimizing current profitability, or reduce the company's cash available to redeem or repay the investor's interest.

Dilution. Investment return depends, in part, on the investor's ultimate percentage ownership of the company. If the company sells more equity, the price paid for additional equity can affect the investor's return. Since dilution can adversely affect the investor's return, the investor wants protection, frequently in the form of "anti-dilution" clauses.

Alternative investment structures

Most institutional private placements are for companies that are "C" corporations for federal income tax purposes while many smaller investments are for tax "pass-through" entities such as "S" corporations, limited partnerships or limited liability companies. For institutional equity investors acquiring an interest in a "C" corporation, the goal of receiving a return of and on capital is best achieved by purchasing a convertible preferred stock with a liquidation preference and a cumulative dividend, or a redeemable preferred stock coupled with common stock or warrants.

Because "S" corporations can have only one class of stock (except for differences in certain voting rights), preferred stock is not an investor option, nor can corporations or partnerships invest in "S" corporations. Debt transactions are generally structured as convertible debt or subordinated debt with common stock or warrants.

Convertible preferred stock. The typical convertible preferred stock

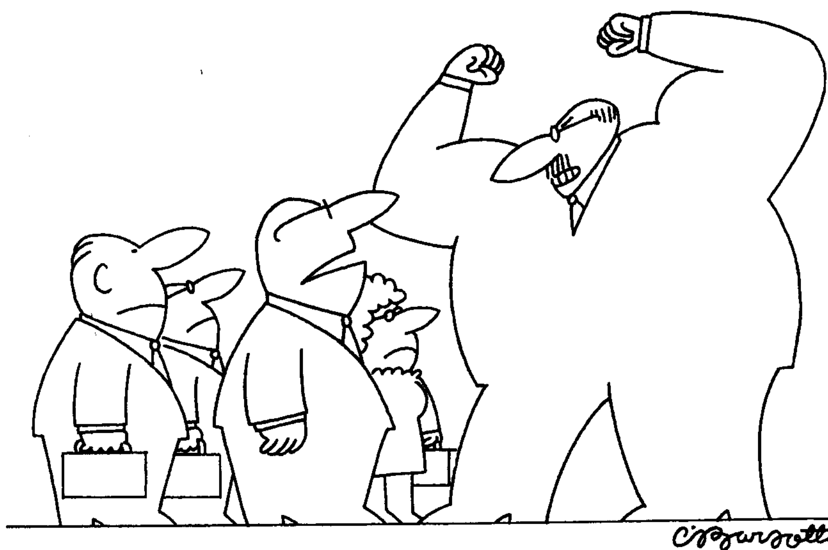
contains most of the following features:

- *Liquidation preference.* On liquidation or sale of the company, the investor receives an amount usually equal to the original investment prior to any distributions to common stockholders. A variation is a "participating preferred" where the investor after receiving an amount equal to the liquidation preference is able to convert the preferred stock into common stock and participate in the liquidation again as a common stockholder. In either case, the investor receives a return of capital before the common stockholder.
- *Dividend preference.* The preferred stock dividend must also be paid in full before any common stock dividends are paid. In most cases the dividend is cumulative, so that if the dividend is not paid currently (by design or inability), the dividend nonetheless continues to accumulate as a debt to the preferred stockholder. The investors may agree that payment may be deferred for a period of years to avoid a cash drain on the company in early stages of operations. At the latest, accumulated dividends are paid in the event of a sale or an initial public offering (IPO), providing the investor with a return on capital.
- *Convertibility.* The investor's need to achieve a high rate of return can be satisfied if the preferred stock is convertible into common stock. Convertibility permits the preferred stockholders to choose between receiving a liquidation and dividend preference on the preferred stock *or* converting to common stock. Obviously, conversion only occurs if the amount to be received by owning the common stock after conversion exceeds the liquidation and dividend preference amounts.

To protect the company from having two classes of stock outstanding after going public (a situation considered by underwriters to be disadvantageous in a young company), convertible preferred stock is usually required to convert automatically into common stock on the occurrence of an IPO that exceeds a minimum aggregate dollar amount and stock price. These minimums protect the investor from losing preferred stock privileges by having to convert to common stock in connection with an IPO that is so small that no real liquidity or public market has been created.

In general, the rate of conversion for preferred stock to common stock is initially on a one-for-one basis. "Anti-dilution" provisions protect the preferred stockholder against the consequences of the company selling stock in a later offering at a lower price than that at which it sold the preferred stock, "diluting" the value of the preferred stock. Anti-dilution provisions can be "weighted average" provisions, where the number of shares issued at a lower price is taken into account by reducing the investor's conversion price and/or increasing the number of shares issued on conversion. "Rachet" anti-dilution provisions are more drastic and reduce the conversion price to the lowest price at which the most recent security offering was made.

- *Redeemability.* If after a specified period (e.g., seven years) the company is not sold or publicly owned, the investor can force the company to redeem the preferred stock at the liquidation price plus cumulative dividends. A common variation is to provide "penalty" provisions, i.e., the liquidation price or dividend rates increase on an accelerating basis beginning in year 5, 6 or 7. This gives the company an additional incentive to implement an exit strategy because the lapse of time increases the investor's percentage share of any proceeds.
- *Voting rights.* The preferred stock usually has a number of votes equal to the number of shares of common stock into which it is convertible, and may have the right to elect a disproportionate percentage of the board of directors, frequently a majority.
- *Registration rights.* Investors generally require "demand" or "piggyback" registration rights to have their common stock registered after the preferred stock has been converted into common stock, normally when the company will be mature enough to merit public registration. The filing and prepara-



'Oh, stop flexing, Dinsdale, get your lawyers and let's deal.'

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tion costs for one or two registrations are usually paid for by the company, although the investor pays the direct underwriting costs related to the investor's own shares. "Piggy-back" means that investors may sell their own shares in the company's public offering (usually subject to underwriter approval).

These rights are desirable because even after an IPO, the investor may not be able to dispose quickly of large blocks of stock without an underwriting because of securities-law restrictions or market conditions.

- *Rights of first refusal.* Preferred stockholders generally receive the right to participate *pro rata* in any subsequent offerings of stock by the company. This contractual equivalent of statutory preemptive rights permits the investor's maintenance of a *pro rata* ownership interest without dilution through the issuance of additional securities to outside investors.
- *"Come-along" and "take-along."* One of the major exit strategies is a sale of stock. Preferred stockholders obtain the right to sell their stock ("come along") at the same price as the entrepreneur if the entrepreneur sells shares. They may also require that the entrepreneur sell the entrepreneur's stock (i.e. be "taken along") if the investors want to sell, enabling the investors to sell the entire company to a potential buyer.
- *Negative covenants.* The company agrees not to take certain actions that can adversely affect preferred stock without preferred stockholders' consent. These actions include: (1) sell additional capital stock (other than under employee stock plans); (2) pay common-stock dividends or repurchase stock; (3) borrow money, or make loans or guarantees (except to or for subsidiaries); (4) merge or sell substantially all of its assets (unless the company is the survivor) and (5) liquidate.

Redeemable preferred stock. Some investors prefer units combining redeemable *non*convertible preferred stock with common stock. This gives the investor additional leverage and a result slightly different from convertible preferred stock, but is less desirable to the company than convertible preferred stock.

A typical investment might consist of a $100,000 unit comprised of shares of redeemable preferred stock valued at $95,000 and shares of common stock valued at $5,000. The redeemable preferred stock would be similar to the convertible preferred stock except that the investor cannot convert. Redemption by the company of the preferred stock leaves only the investor's common stock outstanding.

This permits investors after having given the company a reasonable opportunity to otherwise create an exit, to liquidate their investment by redeeming 95 percent of their cost, with a return on capital (i.e. dividends), while retaining their equity position in the company through ownership of the common stock.

Convertible debt. Convertible debt is debt that is convertible, usually into common stock of the company, at a predetermined conversion rate. This rate may be subject to anti-dilution provisions similar to those described in the convertible preferred stock section. The advantage to the investor is the receipt of interest on the investment while the investor assesses whether the company is successful enough to justify converting debt into stock.

Subordinated debt with common stock or warrants. In transactions to individual investors, the security sold is frequently structured as a unit. The majority of the purchase price is allocated to interest-bearing subordinated debt, and the balance to common stock (the relative ratios being subject to negotiations as well as applicable IRS debt/equity rules). Thus an "S" corporation can sell an investment with a substantial liquidity strategy (repayment of the principal) and return on capital (interest), paralleling the downside protection of the liquidation preference and accumulated dividend features of preferred stock. The investor's potential for an above average rate of return resides in the common stock that the investor continues owning after debt repayment.

The single-class-of-stock rule requires careful analysis so that the sale of a unit does not inadvertently create a prohibited second class of stock, eliminating the company's desirable "S" corporation status. Subordinated notes accomplish the company's goals of selling a security treated as equity for borrowing purposes but not for tax purposes (unlike a preferred stock dividend, which is *not* deductible, interest *is* deductible).

Effect of structure on return

Comparing the investment return on the same investment amount under alternative capital structures illustrates the dramatic economic consequences of *structure.* The owner of a "C" corporation wants to raise $100,000 by selling a one-third interest in the company, and believes that the company will be sold, or go public, five years later for at least $700,000. If the owner is correct, one-third ownership of common stock in the company will result in a value of $233,333 (a $133,333 appreciation) or approximately a 20 percent annual rate of return to the investor.

The owner considers selling investors one-third of the company in the form of either: (1) common stock; (2) cumulative convertible preferred stock, convertible into one-third of the company's common stock, with a $100,000 liquidation preference and a cumulative dividend; or (3) a unit consisting of subordinated debt and common

stock. The owner's lawyer suggests that the owner examines the potential investment returns to the owner and the investors, assuming that the company is ultimately sold in year No. 5 either for $250,000 or $1 million.

For deals of this nature, the current "coupon" for investments is approximately 8 percent, i.e. the fixed portion of return *on* capital. To be competitive in the marketplace, the convertible preferred stock should have a cumulative dividend preference of 8 percent, which would accumulate and not be paid until the earlier of a sale or an IPO.

To generate an 8 percent return on $100,000, the investment would consist of a unit of $80,000 of subordinated debt and $20,000 for common stock equal to one-third of the then issued and outstanding common stock *after* issuance of the new shares to the investor. To keep the "coupon" on the unit identical with the return on capital for preferred stock, the subordinated debt will accrue interest at the rate of 10 percent, with interest and principal to be paid in a lump-sum payment after five years. A 10 percent interest rate on $80,000 of subordinated debt provides an effective rate of interest of 8 percent on the entire $100,000 unit, even though technically only 80 percent of the unit is debt, i.e. 8 percent x $100,000 is $8,000, just as 10 percent x $80,000 is $8,000.

The table on this page details the results to the investor and owner under three different investment structures: (1) common stock, (2) convertible preferred, and (3) a unit consisting of subordinated debt combined with common stock. The table also contrasts the consequences if the company is sold five years later for $250,000 (below expectations) or $1 million (above expectations).

Conclusion

The form of the investment in a company will have a significant effect on the relationship between the investor and the company during the life of the investment, and in determining the final economic consequences to both parties. In the sale for $250,000, the investor's return ranges from a *loss* from an investment in common stock to an internal rate of return (IRR) of 11 percent from an investment in subordinated debt with common stock, all from an investment that many business owners would characterize as the investor owning one-third of the company.

The difference in rate of return is present, but less pronounced, in a successful transaction. Common stock ownership results in an IRR of 28 percent while unit ownership results in a 33 percent rate IRR.

As the examples demonstrate, certain investment forms and negotiated terms protect the downside of a soured deal, and can more modestly improve financial returns in a successful company. Structural elements can help balance the risk/reward ratio, and address managerial concerns as well. Hopefully, a negotiated balance will permit a company to raise desired funds while an investment structure that does not recognize and respond to both investor and company concerns will fail.

The lawyer's opportunity and obligation is to assist clients in making a knowledgeable assessment of the financing alternatives and consequences. BL

Security purchased by investor	Sale of company for $250,000	Sale of company for $1 million
common stock equal to 1/3 of equity of company for $100,000	Investor receives 1/3 of $250,000, or $83,333 (a loss of $16,333) Owner receives $166,667.	Investor receives 1/3 of $1 million, or $333,333 (approximately a 28 percent IRR) Owner receives $666,667.
8 percent cumulative convertible preferred with $100,000 liquidation preference, convertible into 1/3 of common stock	Investor receives $140,000, consisting of $40,000 in dividends (8 percent X $100,000 X 5 years) and $100,000 liquidation preference (approximately a 7 percent IRR) Owner receives $110,000.	Investor converts preferred stock and receives 1/3, or $333,333 (approximately a 28 percent IRR). With participating preferred it would be $333,333 plus $140,000 Owner receives $666,667.
unit, consisting of $80,000 of 10 percent subordinated debt and $20,000 for 1/3 of common stock	Investor receives $166,333 consisting of repayment of $80,000 debt, $40,000 in interest, and 1/3 of remaining $130,000 or $43,333 (approximately an 11 percent IRR) Owner receives $83,667.	Investor receives $413,333, consisting of repayment of $80,000 debt, $40,000 in interest, and 1/3 of remaining $880,000 or $293,333 (approximately a 33 percent IRR) Owner receives $586,667.