

**VENTURE CAPITAL -- AN OVERVIEW OF THE
BASIC ISSUES AND CHALLENGES FOR ENTREPRENEURS**

A NETPRENEUR.ORG SPECIAL REPORT

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INTRODUCTION

At several recent Netpreneur.org Coffee & DoughNuts events, including the May 23rd program on Ratchets, Cramdowns and Other Scary Venture Capital Terms as well as the recent Startup.com film event on July 17th, many members of our Netpreneur community posed questions on the fundamentals of structuring venture capital transactions, including many that time prevented the panel from addressing. Clearly there is a lot of interest in this topic among our region's technology entrepreneurs, but there is also a lot of confusion. Rather than deal directly with the dozens of specific questions posed at these two events, this Netpreneur.org special report will provide an overview of some case concepts which I hope will be helpful to you in the growth and financing of your business.

OVERVIEW AND HISTORY OF VENTURE CAPITAL

Today's institutional venture capital industry has its roots at the turn of the twentieth century, when wealthy families like the Rockefellers and DuPonts provided risk capital to small growing companies. Following World War II, a few institutional venture capital companies were formed, the most notable being American Research and Development Corporation in Boston in 1946. Today, there more than 800 venture capital investment firms providing capital to more than 2,200 early-stage and rapidly growing companies each year although the trend has slowed in 2000 and 2001 during the economic and technology downturns.

Owners and managers of early-stage growing companies often have mixed views toward the institutional venture capital industry. On one hand, they welcome the money and management support they desperately need for growth, but fear the loss of control and various restrictions that are typically placed on the company by the investment documents. In order to achieve the delicate balance between the needs of the venture capitalist and the needs of the

company, business owners and managers must understand the process of obtaining venture capital financing.

THREE TYPES OF VENTURE CAPITALISTS

In general, there are three different types of traditional institutional pools of venture capital, though in recent years the lines between the three may be blurring. These include:

Public and Private International Venture Capital Firms. These firms are typically organized as limited partnerships which themselves seek capital from venture investors, trusts, pension funds, insurance companies, among others. They in turn manage and invest in high-growth companies. Venture capital firms tend to specialize in particular niches, either by the business's *industry, territory or stage of development*. Their investors expect a certain success rate and Return on Investment (ROI), which is critical to the firm's future ability to attract additional capital and track record.

SBIC/MESBIC. The Small Business Investment Act, enacted in 1958, established a national program for licensing privately owned small business investment companies (SBIC). Minority-Enterprise IBIC's were added by a 1972 amendment to the Act. Although the SBIC program has experienced some difficulty, it currently remains an integral part of the organized venture capital community. The program allows the SBA to grant licenses to certain types of venture capital firms that are eligible to borrow money from the Federal Government at very attractive rates in exchange for certain restrictions on deal structures as well as the types of businesses which the SBIC can provide capital.

Corporate Venture Capital Divisions. These include venture-capital divisions established by large corporations such as Intel and Motorola, usually in hopes of funding small companies that have technology or resources that larger companies want or need. The investment

is often structured more like a quasi-joint venture, because corporate venture capital often brings more to the table than just money, such as access to the resources of these large companies. Corporate venture capital efforts typically revolve around the corporation's goals to incubate future acquisitions; gain access into new technologies; obtain intellectual property licenses; provide work for unused capacity; technology entrepreneur thinking to current corporate staff; final hours for excess cash; and break into new markets.

NARROWING THE FIELD

Preparation is the key to obtaining an initial meeting with the institutional venture capitalist. There are three central components to the preparation process: business and strategic planning; effective networking; and narrowing the field.

A well-written business plan and financing proposal is a necessary prerequisite to serious consideration by any sophisticated source of capital. Effective networking means using professional advisers, commercial lenders, investment bankers and consultants who may be able to assist you to get the business plan into the hands of the appropriate venture capitalists. Institutional sources of capital are often flooded with unsolicited, "non-introduced" plans that are more likely to end up in a wastebasket than before an investment committee. Remember that the average venture capital firm will see thousands of business plans per year, provide a return phone call on only a few dozen candidates and may actually close only four to six deals per annum (or even less these days, where the focus may be on existing portfolio companies), so you need to find ways to increase your chance of survival as the field of choices rapidly narrows. Finally, most venture capitalists have certain investment preferences regarding which companies they will include in their investment portfolio. These preferences may be based on the nature of the company's products and services, geographic location, projected rates of return, stage of

development or amount of capital required. Rather than waste precious resources by blindly sending business plans to any and all venture capitalists in your region, take the time to research the venture-capital industry to match the characteristics of the proposed investment with the investment criteria of the targeted firm.

It may turn out that your company's stage of development will determine which kind of venture capital investor you'll approach, and the structure of the financing you'll receive, so it's important to identify which stage of business development financing you require before embarking on the search for capital.

The first level is *seed financing*, in which small amounts of capital are provided to the company for initial product feasibility studies, development, market research, refinement of strategies and other preliminary analyses.

The next level of financing is *start-up* or *early stage financing*, which is generally for completion of product development, recruitment of a management team, refinement of the long-term business plan and the commencement of marketing efforts. Financing for companies at the starting point in their growth and development is tough to get because of the elimination of capital gains differential by the Tax Reform Act of 1986. Venture capitalists are now investing in later-stage companies, with a greater emphasis on the company's ability to generate current income and return to the investors.

Now we come to *first-stage* financing, which usually funds the first phase of the full-scale manufacturing, marketing and sales. It is also at this stage that any missing components of the management team are completed.

Second-stage financing is typically for a company that has begun its production and distribution, has established inventories, contracts and accounts receivable, but now needs working capital to fuel expansion.

Third-stage financing is usually for a company that is already operating at a profit, but needs capital to research and develop new products, expand its physical facilities or make a significant increase in sales and marketing efforts.

Finally, in *bridge financing*, venture capitalists will provide capital to a company which expects to go public within the next 12 months, but requires additional working capital to bridge the gap, but this type of financing will be very rare as the number of initial public offerings have grounded to a virtual halt. Firms will also consider providing capital to finance mergers and acquisitions, joint ventures, leveraged management, buy-outs or recapitalization, efforts to "go private" or other kinds of transactions, if the return on investment meets their criteria.

PREPARING FOR THE MEETING WITH THE VENTURE CAPITALISTS

If your business plan submission survives the rigid initial review of most institutional venture capital firms, then the key to your first meeting and success thereafter is ***PREPARATION!***

Keep in mind the following points:

- (a) Have a dress rehearsal. You need to rehearse your presentation many times, using a "moot court." This involves different audiences asking different questions, replicating the actual meeting that you'll have with the managers of the venture capital firm. Make sure your rehearsal audiences (such as lawyers, accountants, business school professors, and entrepreneurs who have raised venture capital) have the background and the training to ask the right questions (including the tough ones) and be able to critically evaluate your responses. Do your homework on the venture capital firm and learn what their "hot buttons" may be so that you can address key issues in your presentation. As the saying goes, "You never get a

second chance to make a first impression.” The rehearsals will help you survive the first meeting and get to the next steps. Be prepared for the tough questions and don't be scared, intimidated or upset when the really hard ones start flying at you. If the venture capital firm's team doesn't ask tough questions, then they are not "engaged" into your presentation. If they are not engaged enough to beat you up a little, then there will probably be no next steps and no deal.

- (b) Have a mentor. It's always helpful to have a venture-capitalist coach or mentor who has himself either raised venture capital or been an adviser on or negotiated venture-capital transactions. The mentor or coach can help stay focused on the issues that are important to the venture capitalists and not waste their time. The mentor can reassure you during the difficult and time-consuming process, teach you to remain patient, optimistic and level-headed about the risks and challenges that you face.

- (c) Have a detailed game plan. Prepare a specific presentation that isn't too long or too short (usually 15 minutes is about right). Don't attempt to “read” every word of your business plan or put every historical fact of your company on a Power Point slide. Keep it crisp and focused and be prepared for questions and to defend your key strategic assumptions and financial forecasts. Remember that every minute counts. Even the small talk at the beginning of the meeting is important because the seasoned venture capitalist is sizing you up, learning about your interests and looking for the chemistry and the glue that is key to a successful relationship.

- (d) Have your team available to meet the venture capitalist. Don't overlook the "personal" component of the evaluation. In many cases it can be the most important factor considered in the final decision. The four "Cs"—camaraderie, communication, commitment and control (over your ego)—may make or break the outcome of the meeting. Any experienced venture capitalist will tell you that, at the end of the day, the decision depends on the strength of the people who will be there day to day to execute and manage the future of the company. The venture capitalist will look for a management team that's educated, dedicated and experienced (and ideally has experienced some success *as a team* prior to this venture). The team should also be balanced, with each member's skills and talents complementing each other so that all critical areas of business management are covered—from finance to marketing and sales to technical expertise.
- (e) Have passion but not rose-colored glasses. Many entrepreneurs fail to make a good impression in their initial meeting with the venture capitalist because they come on too strong or not strong enough. The experienced venture capitalist wants to see that you have a passion and commitment to your company and to the execution of the business plan. However, he or she does not want to be oversold or have to deal with an entrepreneur who is so enamored of an idea or plan that he or she can't grasp its flaws or understand its risks.
- (f) Have a way to demonstrate your personal commitment to the project. All venture capitalists will look to measure your personal sense of commitment to the business and its future. Generally, venture capitalists won't invest in

entrepreneurs whose commitment to the business is only part-time or where their loyalty is divided among other activities or ventures. In addition to fidelity to the venture, the investor will look for a high energy level, a commitment to achievement and leadership, self-confidence, and a creative approach to problem solving. You will also have to demonstrate your personal financial commitment by investing virtually all of your own resources into a project before you can ask others to part with their resources. Remember, any aspect of your personal life, whether it's good, bad or seemingly irrelevant, may be of interest to the venture capitalist in the interview and due diligence process. Don't get defensive or be surprised when the range of questions are as broad as they are deep—venture capitalists are merely trying to predict the future by learning as much as possible about your past and current situation.

- (g) Have an open and honest exchange of information. One sure deal killer for venture-capital firms is if you try to hide something from your past or downplay a previous business failure. A seasoned venture capitalist can and will learn about any skeletons in your closet during the due diligence process, and will walk away from the deal if they find something that should have been disclosed to them at the outset. A candid, straightforward channel of communication is critical. A previous business failure may be viewed as a sign of experience, provided that you can demonstrate that you've learned from your mistakes and figured out ways to avoid them in the future. On a related note, you must demonstrate a certain degree of flexibility and versatility in your approach to implementing your business plan. The venture capitalists may have suggestions on the strategic direction of the company and will want to see that you are open-minded and

receptive to their suggestions. If you're too rigid or too stubborn, they may view this as a sign of immaturity or that you're a person with whom compromise will be difficult down the road. Either one of these can be a major deal "turn-off" and a good excuse to walk away.

- (h) Have a big market and a big upside. Make sure your Business Plan and your presentation adequately demonstrates the size of your potential market(s) and the financial rewards and healthy margins that strong demand will bring to the bottom line. A venture capitalist who suspects that your product or service has a narrow market, limited demand and thin margins will almost always walk away from the deal. If your target market is too mature with already established competitors, then the venture capitalist may feel the opportunity is too limited and will not produce the financial returns that they expect. They're looking for a company that has a *sustainable competitive advantage*, demonstrated by a balanced mix of products and services that meet a *new* market need on both a domestic and overseas basis. Remember that most venture capitalists want a 60% to 80% return for seed and early-stage or post-launch deals and at least a 25% to 35% return on latter-stage and mezzanine level investments. When the S&P 500 offers 30% returns and when the average investor can double his or her money with investments in lower-risk companies like General Electric and Intel, then your business plan and presentation had better demonstrate that the venture capitalists' money will be better served in your company.

DUE DILIGENCE IS A TWO-WAY STREET

At the same time that your Business Plan is under the microscope during the venture capitalist's evaluation and due diligence, you should be assessing the prospective venture capitalist's strengths and weaknesses. As long as the capital markets remain strong, your ability to be selective in choosing which venture capital proposal will be acceptable will remain available. Consider the following questions when determining whether the venture capital firm fits into your current and projected requirements:

- * How well does this firm know your industry? How often does it work with companies that are at a development stage similar to yours? To what extent has it worked with owners and managers of more seasoned companies in a turnaround situation?
- * What assistance can the venture capitalist bring to you in terms of management expertise, industry contacts and support services?
- * What is the reputation of this firm within the financial community? If this firm is to serve as the "lead investor," then how effective will it be in helping to attract additional co-investors? Has the firm asked for any special reward or compensation for serving as lead investor? What effect will this have on the willingness of other co-investors to participate?
- * Will this firm be able to participate in later rounds of financing if the company continues to grow and needs additional capital?

To answer these questions, you should speak with investment bankers, attorneys, accountants and other venture capitalists who are familiar with this particular firm. Most important, you should speak with owners and managers of other companies in the investor's portfolio, to determine the level of support, conflict and communication typically provided by

the firm and be sure to talk to both successful and unsuccessful portfolio companies. Find out how the venture capitalist reacted to companies that got into trouble, not just those that outstripped projections.

NEGOTIATING AND STRUCTURING THE VENTURE CAPITAL INVESTMENT

The negotiation and structuring of most venture capital transactions depends less on "industry standards", "legal boilerplate" or "structural rules-of-thumb" and more on the need to strike a balance between your needs and concerns and the venture capitalist's investment criteria. Initial negotiations and alternative proposed structures for the financing will generally depend on an analysis of the following factors:

Your Main Concerns

- Loss of management controls;
- Dilution of your personal stock;
- Repurchase of your personal stock in the event of employment termination, retirement or resignation;
- Adequate financing;
- Security interests being taken in key assets of the company;
- Future capital requirements and dilution of the founder's ownership; and
- Intangible and indirect benefits of venture capitalist participation, such as access to key industry contacts and future rounds of capital

Their Main Concerns

- Your company's current and projected valuation;

- Level of risk associated with this investment;
- The fund's investment objectives and criteria;
- Projected levels of return on investment;
- Liquidity of investment, security interests and exit strategies in the event of business distress or failure ("Downside Protection");
- Protection of the firm's ability to participate in future rounds if company meets or exceeds projections ("Upside Protection");
- Influence and control over management strategy and decisionmaking;
- Registration rights in the event of a public offering; and
- Rights of first refusal to provide future financing

Concerns for Both of You

- Retention of key members of the management team (and recruitment of any key missing links);
- Resolution of any conflicts among the syndicate of investors (especially where there is a lead investor representing several venture capital firms);
- Financial strength of the company post-investment; and
- Tax ramifications of the proposed investment.

Negotiation regarding the *structure* of the transaction will usually revolve around: the types of securities involved and the principal terms of the securities. The type of securities ultimately selected and the structure of the transaction will usually fall into one of the following categories:

- (a) Preferred Stock. This is the most typical form of security issued in connection with a venture capital financing of an emerging growth company. This is because of the many advantages that preferred stock offers an investor—it can be converted into common stock, and it has dividend and liquidation preference over common stock. It also has anti-dilution protection, mandatory or optional redemption schedules, and special voting rights and preferences. As valuations shrink, it is critical to factor these preferences into your own exit strategy. For example, if you have raised \$10 million in venture capital so far and the company is about to be sold for \$11 million, the venture capitalists will typically be made whole first, leaving only \$1 million to be divided among the common shareholders, which include the founders of the company as well as all of the key employees who may have participated in the company's stock option plan.
- (b) Convertible Debentures. This is basically a debt instrument (secured or unsecured) that may be converted into equity upon specified terms and conditions. Until converted, it offers the investor a fixed rate of return and offers tax advantages (for example, deductibility of interest payments) to the company. A venture capital company will often prefer this type of security for higher-risk transactions because they'd prefer to enjoy the position of a creditor until the risk is mitigated or in connection with bridge financing, whereby the venture capitalist expects to convert the debt to equity when additional capital is raised. Finally, if the debentures are subordinated, commercial lenders will often treat them as equity on the balance sheet, which enables the company to obtain institutional debt financing.

- (c) Debt Securities With Warrants. A venture capitalist will generally prefer debentures or notes in connection with warrants often for the same reasons that convertible debt is used, namely the ability to protect downside by being a creditor and ability to protect upside by including warrants to purchase common stock at favorable prices and terms. A warrant enables the investor to buy common stock without sacrificing the preferred position of a creditor, as would be the case if only convertible debt was used in the financing.
- (d) Common Stock. Venture capitalists rarely choose to initially purchase common stock from a company, especially at early stages of its development. You see, straight common stock offers the investor no special rights or preferences, no fixed return on investment, no special ability to exercise control over management and no liquidity to protect against downside risks. One of the few times that common stock *might* be selected would be if you wish to preserve your Subchapter S status under the Internal Revenue Code, which would be jeopardized if you authorized a class of preferred stock. Finally, you should be aware that common stock investments by venture capitalists could create "phantom income." This would have adverse tax consequences for employees if stock is subsequently issued to them at a cost lower than the price per share paid by the venture capital company.

Once you and the potential investors have selected the type of security you'll use, you must take steps to ensure that the authorization and issuance of the security is properly carried out under applicable state laws. For example, let's say that your corporate charter doesn't currently provide for a class of preferred stock. As a result, you must prepare articles of

amendment, get them approved by your board of directors and shareholders, and file them with the appropriate state corporation authorities.

The nature and scope of the various rights, preferences and privileges that will be granted to the holders of the newly authorized preferred stock will be the focus of negotiation between you and the venture capitalist. Specifically, the terms and conditions of the voting rights, dividend rates and preferences, mandatory redemption provisions, conversion features, liquidation preferences and the anti-dilution provisions (sometimes referred to as "ratchet clauses") are likely to be hotly contested. In addition, if any portion of the financing from the venture capitalist includes convertible debentures, then negotiations will also focus on term, interest rate and payment schedule, conversion rights and rates, extent of subordination, remedies for default, acceleration and pre-payment rights and underlying security for the instrument.

The kind of protection the venture capitalist demands will depend, in part, on the specific history of your company and its corporate and capital structure. For example, let's say that several majority shareholders of the company are your family members, and that in the past you've authorized certain shares of common stock for issuance at low prices to relatives. In order to protect against dilution upon conversion of the preferred stock (or the convertible debentures), the venture capitalist may require that certain "ratchet" provisions are built into the conversion terms of the preferred stock when you amend the company's corporate charter. These provisions will adjust the conversion price to allow the venture capitalist to receive a greater number of shares upon conversion than originally anticipated. A "full ratchet" adjusts the conversion price to the lowest price at which the stock issuable upon conversion has been sold. Here's an example of such a provision:

"Adjustment of Conversion Price From the Issuance or Deemed Issuance of Additional Shares of Common Stock. If and whenever the Corporation shall issue or sell, or is, in accordance with the

provisions of this subparagraph, deemed to have issued or sold any shares of Common Stock for a consideration per share less than the Conversion Price in effect immediately prior to the time of such issue or sale, then forthwith upon such issue or sale the Conversion Price shall be reduced to the price at which such shares of Common Stock are issued or sold or are deemed to have been issued or sold. Shares issued without consideration shall be deemed issued or sold at a price of \$0.01 per share or the then par value of a share of Common Stock of the Corporation, whichever is less."

There are several other types of ratchet clauses, generally known as "partial ratchets", which adjust the conversion price based on some weighted average formula where shares issuable upon conversion have been issued at a variety of different prices. This type of partial ratchet is generally fairer to you and your stockholders. Finally, you may wish to negotiate certain types of stock sales, such as those pursuant to an incentive-based employee stock option plan, which will be exempt from the ratchet provisions.

Once you and your potential investors have analyzed all of the key relationship, financial and structural factors from a risk, reward and control perspective, the end result is a *Term Sheet*. The term sheet sets forth the key financial and legal terms of the transaction, which will then serve as a basis for preparation of the definitive legal documentation. The term sheet may also contain certain rights and obligations for both parties, such as an obligation to maintain an agreed valuation, to be responsible for certain costs and expenses in the event the proposed transaction does not take place, or to secure commitments for financing from additional sources (such as the supplemental debt financing that a growing company may seek prior to closing). Often these obligations will also be found in the conditions precedent section of the Investment Agreement.

UNDERSTANDING THE LEGAL DOCUMENTS

The actual executed legal documents described in the term sheet must reflect the end result of the negotiation process between you and the venture capitalist. These documents contain all of the legal rights and obligations of the parties, and they generally include: Series A Preferred Stock Purchase Agreement ("Investment Agreement"), Stockholders Agreement, Employment and Confidentiality Agreement, Warrant (where applicable), Debenture or Notes (where applicable), Preferred Stock Resolution (to amend the corporate charter) (where applicable), Contingent Proxy, Legal Opinion of Company Counsel and a Registration Rights Agreement.

Here's a look at the nature and purposes of these documents (along with sample excerpts and terms):

A. The Investment Agreement. This is where you'll find all of the material terms of the financing. It also serves as a form of disclosure document because the Representations and Warranties portion of the Investment Agreement cover the relevant financial and historical information you make available to the investor. The Representations and Warranties (and any exhibits) also provide a basis for evaluating the risk of the investment and structure of the transaction.

The Investment Agreement will also provide for certain conditions which you must meet prior to the closing. These provisions require you to perform certain acts at or prior to closing as a condition to the investor providing the financing. The conditions to closing are often used in negotiations to mitigate or eliminate certain risks identified by the investor, but usually are more of an administrative checklist of actions which must occur at closing, such as execution of the ancillary documents discussed below.

Perhaps the most burdensome aspect of the investment agreement, and thus the most hotly negotiated, are the various *affirmative* and *negative covenants* that will govern and restrict your future business affairs and operations. Affirmative covenants might include an

obligation to: maintain certain insurance policies, protect intellectual property, comply with key agreements, prepare forecasts and budgets for review and approval by the investors and ensure that certain investors are represented on the board of directors of the company.

Negative covenants might include obligations *not* to: change the nature of your business or its capital structure, declare any cash or asset dividends, issue any additional stock or convertible securities, compensate any employee or consultant in excess of agreed amounts or pledge any company assets to secure debt or related obligations.

In most cases, you can't undertake the acts covered by the various affirmative and negative covenants without the express prior approval of the investors, and such restrictions on activity will last for as long as the venture capitalist owns the securities purchased in the financing.

Finally, the investment agreement will provide remedies for any breach of the covenants or misrepresentation you make. These remedies may require a civil action, such as a demand for specific performance, a claim for damages or a request for injunctive relief. In other cases, the remedies will be self-executing, such as an adjustment in the equity position of the investor, a right of redemption of the investment securities, rights of indemnification, super majority voting rights or a right to foreclose on assets securing debt securities.

B. Amendment to Corporate Charter. In all likelihood, you'll need to amend your corporate to create the Series A preferred stock. The articles of amendment will set forth the special rights and preferences that will be granted to the holders of the Series A preferred stockholders such as special voting rights, mandatory dividend payments, liquidation preferences and in some cases, mandatory redemption rights. In [the box on page TK of the Appendix] Box 8-1, you'll find some sample provisions from a venture capital-driven amendment to a company's charter.

C. Stockholders Agreement. Venture capitalists will often require your principal stockholders to become parties to a stockholders' agreement as a condition to closing on the investment. Any existing stockholders' or buy/sell agreements will also be carefully scrutinized and may need to be amended or terminated as a condition to the investment. The stockholders agreement will typically contain certain restrictions on the transfer of your company's securities, voting provisions, rights of first refusal and co-sale rights in the event of a sale of the founder's securities, anti-dilution rights, and optional redemption rights for the venture capital investors.

For example, the investors may want to reserve a right to purchase additional shares of your preferred stock in order to preserve their respective equity ownership in the company in the event that you later issue another round of the preferred stock. This is often accomplished with a contractual pre-emptive right (as opposed to such a right being contained in the corporate charter, which would make these rights available to *all* holders of the preferred stock), which might read as follows:

"Each of the investors shall have a pre-emptive right to purchase any share of Common Stock or any securities which the company shall issue which are convertible into or exercisable for shares of Common Stock. In determining such right, each investor holding shares of Preferred Stock shall be deemed to be holding the shares of Common Stock into which such Common Stock or Preferred Stock are convertible. Such pre-emptive right must be exercised by each investor within fifteen (15) days from the date that each investor receives notice from the company stating the price, terms, and conditions of the proposed issuance of the shares of Common Stock and offering an opportunity to each investor an opportunity to exercise its pre-emptive rights."

D. Employment and Confidentiality Agreements. Venture capitalists will also often require key members of a management team to execute certain employment and confidentiality agreements as a condition to the investment. These agreements will define each employee's obligations, the compensation package, the grounds for termination, the obligation to preserve and protect the company's intellectual property, and post-termination covenants, such as

covenants not to compete or to disclose confidential information. You'll find a commonly used sample executive employment and confidentiality agreement in the box on page TK of the Appendix.

E. Contingent Proxy. This document provides for a transfer to the venture capitalist of the voting rights attached to any securities held by a key principal of the company upon his or her death. The proxy may also be used as a penalty for breach of a covenant or warranty in the investment agreement.

F. Registration Rights Agreement. Many venture capitalists will view the eventual public offering of your securities pursuant to a registration statement filed with the SEC as the optimal method of achieving investment liquidity and maximum return on investment. As a result, the venture capitalist will protect his or her right to participate in the eventual offering with a Registration Rights Agreement. Generally, these registration rights are limited to your common stock, which would require the venture capital investors to convert their preferred stock or debentures prior to the time that the SEC approves the registration statement.

The registration rights may be in the form of "demand rights," which are the investors' right to *require* you to prepare, file and maintain a registration statement, *or* "piggy back rights," which allow the investors to have their investment securities included in a company-initiated registration. The number of each type of demand or piggyback rights, the percentage of investors necessary to exercise these rights, allocation of expenses of registration, the minimum size of the offering, the scope of indemnification and the selection of underwriters and brokers will all be areas of negotiation in the registration rights agreement.

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Summary Biographical Information

Andrew J. Sherman, Esq. is an internationally-recognized authority on the legal and strategic aspects of entrepreneurship and business growth. A summary of his accomplishments include:

- Mr. Sherman is a senior partner with **McDermott, Will & Emery**, an international law firm with over 1,000 lawyers worldwide, where he manages a multi-million dollar corporate and transactional practice representing Fortune 1000 corporations as well as hundreds of technology-driven, netecentric and rapidly growing businesses. He chairs the firm's regional Emerging Business and Technology practice group as well as chairs the firm's international Franchising, Licensing and Distribution group. His current and previous clients include Intel, Apple Computer, America On-Line (AOL), Texaco, Panasonic, Revlon, Beatrice Foods, Caterpillar, Bell & Howell, Rogers Communications, Sanyo, GAF, Caterpillar, Owens-Corning, Shell Oil, Sears, Metrocall, Bankers Trust, Household Finance Corporation, Pritzker Organization (Hyatt Hotels), MarchFirst (Whittman-Hart and CKS/USWeb), the Western Professional Hockey League and Indian Motorcycles.
- He is the author of eleven (11) books on business growth, capital formation and the leveraging of intellectual property, including the best-selling and critically-acclaimed **Raising Capital** (Kiplingers, 2000), **The Complete Guide to Running and Growing Your Business**, (Random House, 1997) and **Franchising and Licensing: Two Ways to Build Your Business**, (2nd edition) (AMACOM Books, 1999) and **Fast Track Growth Strategies** which is due for release in October of 2001.
- He has appeared as a guest and a commentator on all of the major television networks as well as CNBC's "Power Lunch," CNN's "Day Watch," CNNfn's "For Entrepreneurs Only," USA Network's "First Business," and Bloomberg's "Small Business Weekly" and various other regional and local television broadcasts as well as national and local radio interviews for National Public Radio (NPR), Business News Network (BNN), Bloomberg Radio, AP Radio Network, Voice of America, Talk America Radio Network and the USA Radio Network, as a resource on capital formation, entrepreneurship and technology development.
- He has served as an Adjunct Professor in the Masters of Business Administration (MBA) programs at the **University of Maryland** for twelve (12) years and at **Georgetown University** for six (6) years where he teaches courses on Entrepreneurship and Business Planning, Growth Strategies and New Venture Financing, and has won various teaching awards including the Krowe Award for Teaching Excellence in 2000.
- He serves as **General Counsel** to several of the nation and region's leading entrepreneurship organizations, including the **Young Entrepreneurs Organization (YEO)**, the National Foundation for Teaching Entrepreneurship (NFTE), the Let's Talk

Business Network (LTBN) and the Morino Institute's Netpreneur program, since the inception of these organizations. He was one of the co-founders of the Washington, D.C. regional chapter of the Association for Corporate Growth and serves on the Inner Circle and as a key advisor to the Dingman Center for Entrepreneurship at the University of Maryland.

- Mr. Sherman is a frequent author and serves as a resource for articles in a wide variety of the nation's leading magazines, newspapers and websites including the **Wall Street Journal**, the **New York Times**, **Fortune**, **Investor's Business Daily**, **USA Today**, **Inc.**, **Nation's Business**, **Success**, the **Washington Post**, **Forbes**, **My Business**, **U.S. News and World Report**, **Business Week**, **Money**, **Legal Times**, **Washington Business Journal**, **Crain's**, **Entrepreneur**, CNNfn.com, Inc.com, Fortune.com, Office.com, MSNBC.com, and the Kauffman Center for Entrepreneurial Leadership's EntreWorld.org web sites.
- Mr. Sherman is the Chairman of the Professional Advisory Board of the **National Commission on Entrepreneurship** (NCE), the Chairman of the Technology and Innovation Committee for the **Washington Board of Trade's** Potomac Conference, serves on the Board of Directors of Youth Services America, the Research Institute for Small and Emerging Businesses (RISE Business), NFTE (Former Chairman 1993-1995), YEO, the **Washington Business Journal's** Editorial Advisory Board, **Inc. Magazine's** Business Consulting Services Advisory Board, the **Opportunity International** Board of Governors, the **Gazelles/Masters of Business Dynamics** Advisory Board and serves on the advisory boards of several business incubators and early-stage and rapidly-growing technology companies.
- Mr. Sherman serves as an on-line columnist for two of the internet's leading sites for small and emerging growth companies. He writes the "Can This Business Be Saved?" column for **FortuneSmallBusiness.com** as well as the "View from The Trenches" column for AOL's **Netbusiness.com** and serves as a key member of the **AOL Small and Emerging Business Champions Team**. He is also a frequent contributor to the Kaufman Center for Entrepreneurial Leadership's website, EntreWorld.org.
- He is a frequent national and international lecturer at business conferences where he has delivered speeches and lead seminars on entrepreneurship, capital formation, mergers and acquisitions, the protection and leveraging of intellectual property and business planning for organizations such as **Inc. Magazine** (Growing Your Company, Capital Formation and CEO Symposium Conferences), the **Association of Financial Professionals**, the **Young Entrepreneurs Organization**, the **National Restaurant Association**, **iBreakfast.com**, the **U.S. Chamber of Commerce**, the **New York Venture Group**, the **Dingman Center for Entrepreneurship**, **Netpreneur.org**, the **Baltimore-Washington Venture Group**, the **National Association of Credit Managers**, **PC Expo**, the **International Franchise Association**, **Microsoft's** Small Business Crossing Seminar

Series, the Regional Investment Bankers Association, the Collegiate Entrepreneurs Organization, the Association for Corporate Growth, the American Management Association, the Council for Growing Companies, and various other international and regional business organizations.

- He is the developer and lecturer for several different business growth courses and seminar series, including serving as the author of two workbooks and videos for Kiplinger's, entitled **Growing Your Business** and **Corporate Transition Management and Exit Strategies**, as well as a four-part cyber-conference and workbook on **Mergers and Acquisitions** for the Association of Financial Professionals, a seminar series on **Strategies for Protecting Your Intellectual Property** for Padgett-Thompson, a series of conferences on **Growth-Oriented Distribution Strategies** for the American Management Association and a series of conferences on **Strategies for Doing Business Abroad** for the International Franchise Association.