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WHAT'S THE DEAL? Series

Path to Liquidity in a Private Placement

May 20, 2025

Agenda

- Background on Equity Private Placement Market
- Investing in redeemable and non-redeemable preferred stock
- Typical investor protections and other considerations
- Structuring warrants and anti-dilution provisions
- Planned exit mechanisms for investors
- Rights of first refusal, co-sale rights, drag-along provisions
- Other price adjustment mechanisms

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Reliance on Private or Exempt Offerings

- Even pre-JOBS Act, based on various studies, it was already the case that more capital was being raised in reliance on Regulation D and Rule 144A (in aggregate) than in SEC-registered offerings.
- According to the SEC's Division of Economic and Risk Analysis ("DERA"), between July 1, 2023, and June 30, 2024, for example, the total raised in registered offerings was just over $1.4 trillion, whereas the total raised through exempt offerings was over $3.0 trillion.
  - Amounts raised in private placements are likely to be understated given that many issuers fail to file Form Ds and amounts raised in Section 4(a)(2) offerings are not reported.
  - The amounts raised in registered offerings include debt offerings, whereas the majority of Reg D offerings involve equity or "new capital."

Exemption	Amounts reported/ Estimated to have been raised* (% change YOY)
Rule 506(b) of Regulation D	$1.9 trillion
Rule 506(c) of Regulation D	$137 billion
Regulation A	$1.5 billion
Rule 504 of Regulation D	$246 million
Regulation Crowdfunding	$249 million
Other exempt offerings	$1.1 trillion

***July 1, 2023 – June 30, 2024**

Source: SEC's Office of the Advocate for Small Business Capital Formation 2024 Annual Report

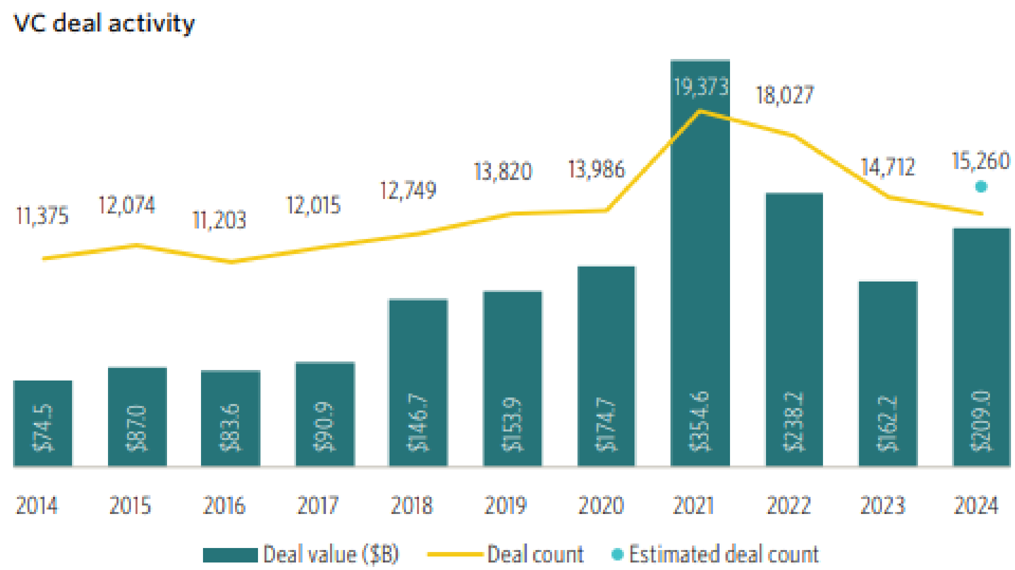
Reliance on Private or Exempt Offerings *(cont'd)*

- Companies are choosing to defer their IPOs and rely on private financing for much longer than in the past.
  - This is evident from various IPO reports.
  - For example, based on statistics for the period from 1/1/12 through 12/31/2024, the median market cap for IPO issuers was approximately $300 million, and the average market cap was $1.4 billion.
  - Approximately 3.1% of IPO issuers have a market cap of $50 million or less.

Source: IPO Vital Signs (excludes SPAC IPOs)

Larger Privately Held Companies

- There are at least 1,249 private companies globally, a slight 2% increase year-over-year, valued by venture capital firms at $1 billion or more. These companies, known as "unicorns," have a cumulative valuation of over $4.3 trillion.
- VC-backed companies raised approximately $161.3 billion in 2023 in 14,712 deals and approximately $209.0 in 2024 in 15,620 deals, surpassing 2020 but still a long way from zero-interest-rate-policy-era highs.



Sources: CB Insights & Pitchbook NVCA Venture Monitor

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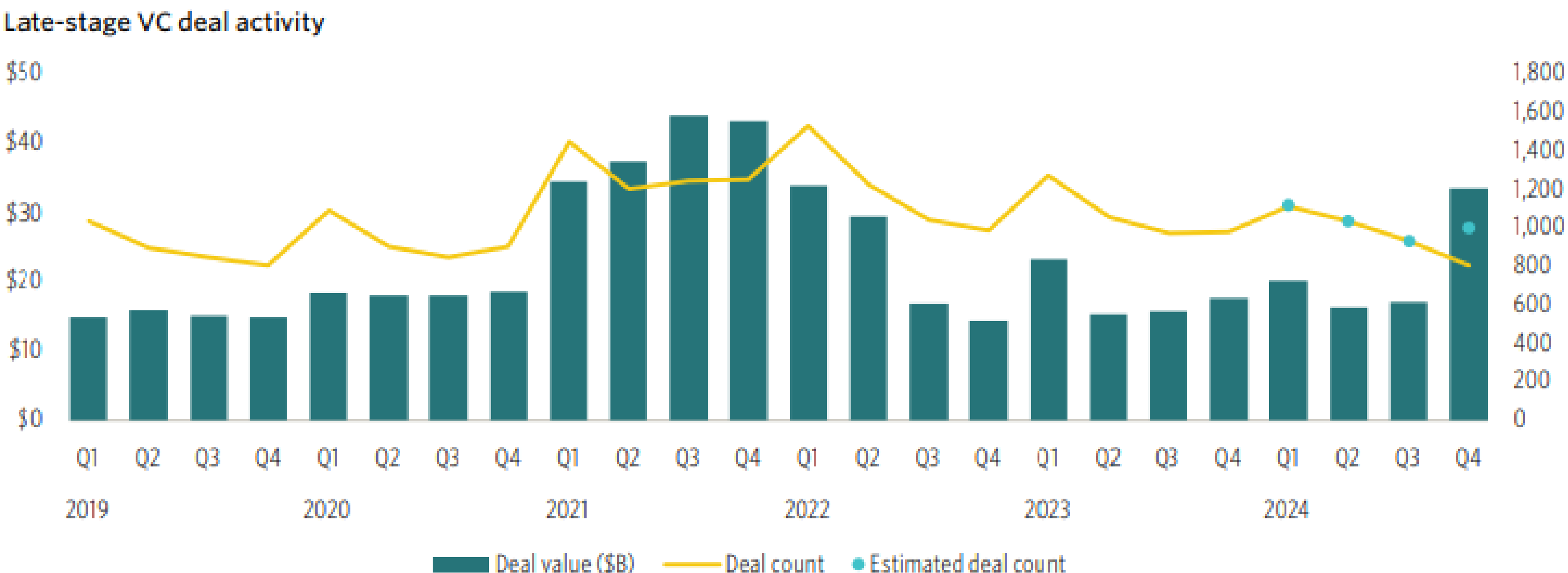
Larger Privately Held Companies *(cont'd)*

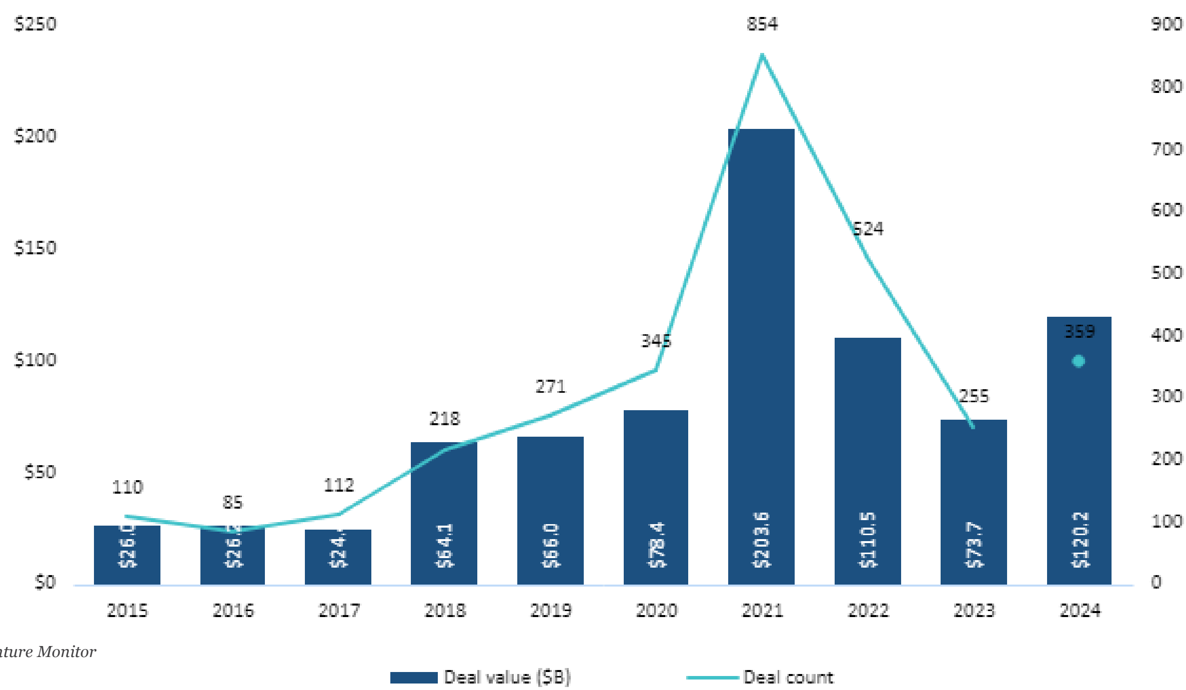
- Post-pandemic late-stage activity continues to be higher than pre-pandemic activity.
- In 2024, companies raised $86.7 billion in 3,872 late-stage deals.



Sources: Pitchbook NVCA Venture Monitor

Larger Privately Held Companies *(cont'd)*

- "Mega rounds," or financings that raise over $100 million, spiked from $73.7 billion in 2023 to $120.2 billion in 2024. The number of mega rounds also increased from 255 to 359.



Sources: Pitchbook NVCA Venture Monitor

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Planning a Path to Liquidity

- Investors in mega-round private placements in unicorns and otherwise often invest using ***preferred stock*** investments and ***warrants***, which is where we will focus (we will also touch briefly upon ***convertible notes***).
- We will consider how investors at the time of investing think about ***planning their eventual exit*** in an environment where unicorns and mega-rounds are more prevalent and traditional liquidity events (such as an IPO or an M&A exit) may not be available for many years.
- The toolkit for protecting these investments includes protective rights during the life of the investment (to improve it from within) and exit rights leading to the end of the investment (to yield an ultimate return).
- These rights require companies to give up significant ***economics*** and ***control*** to finance themselves.

Preferred Stock Basics

- Preferred Stock is popular because it is a flexible instrument that allows for tailored negotiations.
  - The ***size of the check*** and ***investor need*** often has a strong influence on the substance of the terms.
- Companies traditionally benefit because they can raise significant amounts of capital to support operations and growth initiatives in a patient manner without a ***requirement*** to pay back dividends or return capital.
  - By contrast, debt requires regular cash flow to cover interest payments and a mandatory return of principal.
- Investors traditionally benefit because they acquire a position they believe they can nurture into attractive returns over time.

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Preferred Stock Basics *(cont'd)*

- During the life of the investment, investor protections often include:
  - ***Voting rights*** with the common stock on an as-converted basis (except as specified in the charter or as required by law)
  - ***Veto rights*** over various major management decisions, such as:
    - Liquidation or "deemed liquidation" of the Company;
    - Amendment of the charter or by-laws;
    - Issuance of equity securities senior to or *pari passu* with the Preferred Stock;
    - Repurchase or redemption of shares or payment of dividends;
    - Incurrence of debt over a specified threshold;
  - ***Board Designation and Election Rights*** with respect to one or two directors.
    - Sometimes board observer rights.
  - ***Preemptive Rights*** to maintain their economic and control position in the Company
  - ***Information and Inspection Rights*** to monitor the investment and day-to-day managers

Preferred Stock Basics *(cont'd)*

- Economics typically include:
  - A ***liquidation preference***, which is preferential distribution upon a company's liquidation or upon certain "deemed liquidation events," such as a merger, sale of substantially all assets and other change of control transactions.
    - The preference typically equals the original investment amount (sometimes with an accruing dividend), or a multiple (e.g., 1.5-2x) of their investment, before the holders of Common Stock receive any distributions.
  - After payment of the liquidation preference on all preferred, proceeds may be distributed either to:
    - only holders of Common Stock ("**non-participating preferred**"); or
    - the holders of Common Stock and Preferred Stock on a *pro rata*, as converted basis ("**participating preferred**"), though distributions to holders of Preferred Stock may be capped at a return threshold.
  - the ***right to convert*** to Common Stock, which would generally be exercised only if the expected value of holding Common Stock would exceed the expected value to holders of Preferred Stock.
    - Not all preferred is convertible. Non-convertible is sometimes paired with a warrant as a substitute for capturing upside in the common stock.
  - ***Dividends*** at a stated percentage "if, as and when" declared by the Board, the assumption being that dividends will not be declared and paid until liquidation or redemption of the Preferred Stock.
    - Dividends can be ***non-cumulative*** (i.e., no right to receive dividend if not declared) or ***cumulative*** (i.e., they accrue if missed and ultimately add to the liquidation preference).

Preferred Stock Basics *(cont'd)*

- Traditional exit rights include:
  - ***Registration Rights***, which provide IPO liquidity to investors by having the sale of their common shares (following conversion) registered with the SEC, including:
    - ***S-1 Demand Rights***, where a specified percentage of holders may require the Company to register shares on Form S-1 after the Company's IPO or after a certain date if an IPO has not yet occurred;
    - ***S-3 Demand Rights,*** where, following S-3 eligibility, an expedited, short-form registration used for demand rights; and
    - ***Piggyback Rights***, where holders can include shares in a Company-initiated offering, subject to the Company's priority to sell newly issued shares first and to include investors' shares only if the offering is not adversely effected.
  - ***Deemed Liquidation Events***, which include change-of-control mergers, sales of substantially all assets and other change of control transactions, which trigger payment of the liquidation preference unless a requisite percentage of the preferred stock elects otherwise.
  - ***Drag-Along Rights***, which allow large holders to force smaller holders to join in on a secondary block sale of shares or to vote in favor of a merger or other change of control transaction.
- Historically, mandatory or elective ***redemption*** by investors was rare and investors were content to live with various impediments to transfer, including lockups, ROFRs/ROFOs, transfer fees and consents. This has been changing in recent years.

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Preferred Stock: Adding "Teeth"

- Increasingly, deals are adding "**Teeth**" to incentivize payment and other actions during events of non-compliance.
- These are stronger rights than traditionally seen in preferred stock deals that often borrow concepts from the debt world, ***blurring the lines*** at time between equity and debt.
- For example:
  - Mandatory Dividends that look like interest
  - Mandatory/Elective Redemption by Investors (sometimes called "put rights") that look like principal repayment.
  - Protective provisions that look like negative covenants, including restrictions on the incurrence of debt, liens, affiliate transactions and restricted payments.
  - Affirmative covenants, including information rights
  - Most potent: instead of "Events of Default," there are "Events of Non-Compliance" with real consequences.

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Preferred Stock: Adding "Teeth" *(cont'd)*

- ***Events of non-compliance*** may include:
  - Multiple quarters of missed mandatory dividends
  - A failure to mandatorily redeem at a pre-agreed date
  - A failure to sell the company, IPO it or list it or to achieve the same by a pre-agreed date
  - Breaching a financial ratio (e.g., becoming too leveraged)
  - Breaching another covenant (e.g., failing to provide timely reports)

Preferred Stock: Adding “Teeth”*(cont’d)*

- ***Consequences for failing to comply*** may include:
  - Dividend Rachet: An increase to the stated rate of a mandatory cumulative dividend
  - Springing Board Rights: Ability to elect majority of the board, gain observer rights, and/or gain super-voting rights to alter the balance of power.
    - Quorum and notice are also key to monitoring.
  - Springing Protective Provisions: Additional investor veto rights over operations.
    - E.g., a veto over any use of funds other than paying back the investor.
  - Springing Affirmative Rights: E.g., empowering investors to conduct a process to sell or IPO the company
  - Contingency Asset Pools: Asset pools with a value in excess of the liquidation preference that are required to be set aside and sold after a certain period of time upon a failure to redeem.
  - Junior Equity Injections: The junior holders may be required to inject cash into the business at a subordinated level to cure financial ratios and prevent harsher consequences

Preferred Stock: Adding "Teeth" *(cont'd)*

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- Statutory Limits:
  - There is a common law prohibition on dividends and redemptions when a corporation is or would be rendered insolvent on account of such dividend or redemption of shares which legally limits payments of this nature.
  - The rights of preferred investors are subordinate to the rights of creditors. Until debts are paid in full, preferred investors are not entitled to any part of the corporate assets.
- Contractual Limits:
  - Diligence on the corporate's indebtedness and other material contracts may reveal contractual prohibitions on mandatory dividends and share redemptions, breach of which could lead to acceleration of senior obligations.

Structuring Warrants

- The warrant agreement or certificate must be drafted to address:
  - Exercise price
    - Set to avoid tax or accounting issues (409A implications if below fair market value)
    - May include anti-dilution provisions (weighted average or full ratchet) to protect the investor from dilution in future rounds
  - Exercise period
    - Typically ranges from 3 to 10 years
    - Consider how the term affects the company's capitalization and potential exit scenarios
  - Transferability
    - Often restricted to preserve the private nature of the offering and avoid triggering public offering rules
  - Cashless exercise
    - Often allowed, particularly in private companies where liquidity is limited

Structuring Warrants (cont'd)

- When structuring warrants, acceleration and termination provisions are critical elements that define how and when a warrant holder can or must exercise their rights
- Acceleration refers to the advancement of the warrant's expiration or exercise rights due to specific triggering events
  - Common acceleration triggers include change of control transactions, IPO/liquidity events, breaches/events of default, time-based milestones
- Termination refers to when and under what conditions the warrant expires and becomes void
  - Common termination triggers include the fixed expiration date, failure to exercise upon the occurrence of an IPO/liquidity event, termination for cause, non-performance or improper transfer or assignment

Structuring Warrants (cont'd)

- Board approval is typically required for issuance given the potential for dilution
- Evaluate how the warrant interacts with existing investor rights, including preemptive rights, rights of first refusal and drag-along/tag-along rights
- Depending on terms, warrants may be classified as liabilities (instead of equity), affecting the company's financials
- Warrants issued below fair market value can create deferred compensation issues

Prepaid Warrants

- Prepaid warrants are a type of warrant that allows its holder to purchase a specified number of a company's securities at a nominal exercise price.
  - The nominal exercise price is typically as low as $0.01 per share.
- This structure allows the company to receive the exercise price that would be due for a traditional warrant at the time of the warrant's issuance instead of at the time of the warrant's eventual exercise.
- A prepaid warrant is exercisable at the holder's option immediately following its issuance and generally over a lengthy exercise period (as long as ten years) in order to provide the holder with desired ownership flexibility.
- Prepaid warrants are generally issued as part of a larger financing transaction, such as a venture capital investment, minority equity investment or mezzanine financing.
  - Prepaid warrants that are included with common stock as part of a concurrent common stock or unit offering will also impact the total market value analysis for purposes of the 20% rule if the total purchase price is below the company's market value.

Prepaid Warrants (cont'd)

- The purpose of using prepaid warrants is to provide investors that have restrictions on their ability to own a company's securities above a designated ownership threshold (typically, 9.99% or 19.99%) with the opportunity to invest additional capital without violating the investor's ownership restrictions.
  - The ability to delay ownership of a company's common stock is particularly important to holders that already hold a significant percentage of a company's common stock.
  - An investor with a significant ownership interest in voting securities of a company is likely to be considered an affiliate of the company.
- Prepaid warrants are typically structured to include anti-dilution protection.
  - With only a nominal exercise price, prepaid warrants instead proportionally adjust the number of shares underlying the warrant following a specified change to the company's capitalization (instead of the exercise price).
  - The "weighted average" or "full ratchet" anti-dilution provisions that are commonly found in traditional warrants are not used.
- Typically include a fundamental change provision.

Anti-dilution

- Adjustment to conversion ratio
- Triggers
  - Splits, combinations, restructurings (and the like)
  - Down rounds or less-than-purchase-price issuances
- Types of adjustments
  - Mechanical adjustments for splits, combinations, restructurings
  - Less-than-purchase-price issuances
    - Full ratchet
    - Weighted-average adjustments for less-than-purchase-price issuances

Anti-dilution *(cont'd)*

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- Exceptions or "carve-out" examples:
  - Stock option plan issuances
  - Dividends/distributions
  - Mergers/consolidations or acquisitions (may be limited to those which result in less than specified amount of dilution)
  - Conversion of preferred shares
  - Issuances to strategic investor (may be limited to those which result in less than specified amount of dilution)
  - Conversion of securities obtained in connection with any of the foregoing

Convertible Notes

- Private convertible notes are another flexible alternative to convertible preferred stock or non-convertible preferred stock paired with warrants.
- The choice may depend upon factors such as the issuer's covenants and the investor's particular desire to invest in a preferred format versus a note format.
- Notes have a dated maturity while preferred shares can be perpetual or can have a shorter mandatory redemption date
- The issuer could have an early call right under either instrument, which reduces option value
- In both cases the coupon/dividend can be made mandatory, but payment default does not typically lead to acceleration as it does under debt. There are usually less onerous, more incentive-based consequences.
- Sometimes there are acceleration triggers that borrow from debt: e.g., the filing of petition for bankruptcy may be a trigger for an acceleration.
- Convertible notes themselves may also include warrants to increase equity return, the right to vote on an as-converted basis and may come with board seats.
- The substantive differences one might expect among convertible preferred shares, non-convertible preferred shares paired with warrants and convertible notes are continually blurring.

Planned Exit Mechanisms

- Initial public offering
  - Allows investors to sell listed securities on the stock exchange
  - Lock-up – often restrict sales for a period of time post-IPO/liquidity event
- M&A
  - Investors are typically bought out, either for cash, stock in the acquiring company, or a mix
- Secondary sale
  - Must not trigger a public offering or violate resale restrictions
  - Shareholder or Investor Rights Agreements often dictate requirements which may include company consent
  - Sale could be made on a private secondary market

Planned Exit Mechanisms *(cont'd)*

- Redemption right
  - Some investors negotiate the right to force the company to buy back their shares after a certain time
  - How is the redemption price determined?
- Repurchase right
  - Company has the option to buy out the investors' equity stake at a specified price
  - Limited to situations where management seeks to retain control
- International investors may face withholding tax or foreign investment restrictions
- De-SPAC transaction or direct listing may be alternative to IPO but represents a similar liquidity event for existing investors

Right of First Refusal

- Requires the selling stockholder (usually only the Founders) to first find a willing purchaser and, prior to a sale to such purchaser, offer the securities, on the same terms, to the other stockholders of the Company (usually only preferred holders)
- If the offer is refused, the offering stockholder may sell the securities to a third party within a pre-agreed period of time, but only on the terms presented to the other stockholders
- Clearly define what events will trigger the ROFR (e.g., future equity offerings, sales of shares by existing investors, changes of control)
- Specify which types of securities are subject to the ROFR (common stock, preferred stock, convertible notes, etc.)
- Establish how long the ROFR remains in effect—often until an IPO, a sale of the company, or a specific number of years
- Clearly define the period during which the ROFR holder can exercise the right (commonly 10–30 days)

Right of First Refusal (cont'd)

- ROFR is typically granted on a pro rata basis relative to each investor's existing ownership
- Address what happens if not all ROFR holders exercise—can others take more?
- Ensure the ROFR complies with any transfer restrictions under the company's charter, bylaws, or other agreements
- Often the ROFR is transferable to affiliates and successors
- Common exclusions include stock issued under employee plans, strategic partnerships, or debt conversions (carve-outs must be clear and not overly broad)
- Ensure the ROFR aligns with broader governance and fiduciary obligations, particularly if ROFRs are not granted to all shareholders
- Potential investors may discount a company if ROFRs make funding less flexible

Right of First Offer

- Requires the selling stockholder to first offer the stock to be sold to the other stockholders prior to effecting a transfer of such stockholder's shares
- If the other stockholders refuse, the offering stockholder may sell the securities to a third party within a pre-agreed period of time, but on no more favorable terms than were offered to the other stockholders
- Unlike ROFR, the ROFO process does not require the seller to disclose a third-party offer first
- Less disruptive to the market process and often more acceptable to sellers
- Documentation should set a firm offer and response timeline

Tag-Along Rights

- Right to “tag along” or co-sell in the case of a sale of securities by other stockholders (particularly, the founders)
- Tag-along participants must be allowed to sell on the same terms and conditions as the primary seller
- Typical exceptions: estate planning and affiliate transfers
- Founders may negotiate to hold these rights on same basis as investors
- Define what types of transfers trigger the tag-along right (voluntary sales are most common)
- Could only be triggered if an investor sells more than a specified percentage of their shares
- Identify which minority shareholders are entitled to tag along (such as all preferred stockholders or only certain investors)
- The tag-along holders must be given a fixed period (often 10–20 business days) to elect to participate

Drag-Along Rights

- If a majority of investors agree to a sale, minority shareholders can be forced to sell under the same terms
- All shareholders must sell their shares on the same price, terms, and timing as the initiating shareholders
- Triggered when a specified majority (e.g., >50%, >66.67%, or >75% of voting shareholders) agrees to sell
- Helps ensure that exits are not blocked by smaller investors
- Tag-along rights give minority protection, whereas drag-along rights force minority holders to sell
- Public offerings are excluded
- Right requires that a written notice be sent to all affected shareholders
- Shareholders may be required to sign sale agreements, releases or other closing documents
- Drag-along usually supersedes any ROFR or ROFO rights

Preemptive rights

- Right to acquire additional stock of the Company in order to maintain a percentage interest in the Company during an offering
- Only available to stockholders with certain ownership thresholds or on a case-by-case negotiated basis
- Typical Exceptions: employee compensation; strategic partners; vendor and lender relationships; existing options; warrant and convertible securities; mergers and acquisition activity; public offerings
- Usually terminates upon IPO

Information rights

- Audited year-end financial statements
    - Now or in the future?
    - Reviewed?
- Monthly and quarterly income statements and cash flow statements
- Reasonable access?
- Observer rights
- Notices
    - Sales offers
    - Material litigation
- Considerations for competitors

Other Repricing Provisions

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- Private companies are hard to value. Including "***Price Protection***" for investors is a way to help mitigate valuation risk.
- Often used in convertible preferred securities
- Allow the price or conversion rate to be reset based on market or company performance
- Pricing could be adjusted based on the achievement (or failure) of operational, financial or regulatory milestones (common in biotech offerings)
- Could set upper or lower bounds on the effective price investors pay upon conversion or final issuance
- A make-whole provision could be triggered if the price adjusts downward after issuance in which case the company would compensate the investor by issuing additional shares (or cash equivalent) to preserve their original value
- Another alternative is an MFN provision – if the company later offers better terms (lower price, better conversion rate) to new investors, the original investors get the same improved terms
- While these mechanisms protect investors, they can significantly dilute founders or early shareholders

Speakers

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- Brian represents US and foreign private issuers, sponsors, and investment banks in registered and unregistered securities offerings, including:
  - Initial public offerings
  - Follow-on offerings
  - Private placements (including Rule 144A and PIPE transactions)
  - At-the-market offerings
  - Registered direct offerings
  - Liability management transactions
  - Preferred stock and debt offerings
- Brian serves clients on specialty finance, real estate and real estate investment trusts (REITs), business development companies (BDCs), and life sciences company deals. He also assists public company clients with ongoing securities law compliance requirements, listing standards of the major US stock exchanges, SEC public reporting obligations, shareholder-related disputes, and governance matters.

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- Jason maintains a broad capital markets practice, advising on registered and exempt offerings of securities across industries, including real estate/REITs, mortgage and specialty finance, financial services, data centers, energy, consumer goods and aviation.
- He advises issuers, underwriters, investors and other parties in capital-raising and liability management transactions, including initial public offerings, at-the-market offering programs, follow-on common and preferred stock offerings, convertible and exchangeable notes offerings, investment-grade and high-yield debt offerings, debt tender and exchange offers and investments in private equity and debt.
- He also assists domestic and foreign private issuers with ongoing securities law compliance requirements, SEC public reporting obligations, listing standards of the major US stock exchanges and other governance matters.

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