



EQUITY STRUCTURES FOR HIGH GROWTH ENTREPRENEURIAL VENTURES

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I. Introduction

Two categories of entrepreneurial ventures:

- Revenue Model
- Growth Model—this is what we are discussing

II. Capital Structure for Growth Companies

A “ladder” structure based on priority of return v. higher risk and potential for higher return:

Debt:

- Senior debt
- Subordinated debt
- Convertible debt (with warrants)

Equity

- Preferred stock (in multiple series)
- Common stock—voting
- Common stock—non-voting

Premiums and Incentives

- Warrants
- Stock options
- Stock grants

III. Illustration of Authorized Capital Stock Structure

10,000,000 shares of authorized capital stock, \$.001 par value per share

5,000,000 shares designated as common stock, and further classified as:

- 1,000,000 shares class A common stock (voting)
- 3,500,000 shares class B common stock (voting)

- 500,000 shares class C non-voting common stock

5,000,000 shares designated as “blank” preferred stock

- Rights and preferences to be determined when issued

IV. Illustration of Funding Stages

Founders (initial organization)

- Class A common stock for initial capital contributions (*e.g.* IP assignment)
- Nominal or minimal initial company valuation
- Initial board of directors

Early stage investors (*e.g.* angel investors)

- Class B common stock
- Higher pre-investment valuation
- Classified board of directors to accommodate board representation by class

Bridge financing from early stage to second stage funding

- Limited term (short maturity date, to “force” next equity financing)
- Premium interest rate (*i.e.* “junk bond” rates)
- Subordinated to existing indebtedness
- Mandatory conversion into equity at next funding
- Conversion ratio to be based on subsequent equity funding terms
- Optional conversion into common stock if next equity funding does not occur by maturity
- Affirmative and negative covenants

Second stage (larger) funding (*e.g.* angel investors or networks, venture funds)

- ___% series A cumulative convertible preferred stock
- Includes conversion of bridge financing
- Higher (again) pre-investment company valuation
- Cumulative dividend rate
- Liquidation preference
- Participation rights (*i.e.* participate with common stock, after cumulative dividend and liquidation preference are satisfied)
- Mandatory redemption date (to “force” further funding or exit transaction)
- Optional conversion into common stock (1) if exit transaction does not occur by mandatory redemption date, or (2) if exit transaction occurs and common stock would get a better return.
- Automatic conversion into common stock for IPO

- Anti-dilution or “down round” protection
- Affirmative and negative covenants
- Board representation

V. Management, Key Employees, Etc.

Restricted stock grants

- Class C non-voting common stock
- Vesting requirements
- Forfeiture upon voluntary departure or termination for cause
- Repurchase rights upon termination not for cause

Stock option grants (also class C non-voting common stock)

- Strike price to establish growth incentive
- Vesting, forfeiture, repurchase rights, etc.

Tied to restrictions

- Non-disclosure
- Assignment of proprietary rights
- Non-compete

VI. Conclusion

Entrepreneurs (and their counsel) should design the capital structure at an early stage

- While they still have control
- To facilitate growth of capital funding
- And in anticipation of what investors at each funding stage will expect

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Philip Krause has practiced business, corporate and securities law in the Kansas City area for his entire professional career, spanning more than thirty years, focusing primarily on serving entrepreneurs and high-growth technology and life sciences ventures. He has been affiliated with prominent Kansas City-based law firms for most of his career, but Philip is an entrepreneur in his own right and currently has his own private law practice seeking to transform how lawyers interact with entrepreneurial clients and deliver the distinctive range of legal services they require through innovative service delivery models.

Philip's broad-based experience encompasses the entire "life cycle" of high growth ventures, including structuring and organizing the enterprise, establishing relationships with key constituencies (founders, management, investors, etc.), acquiring, protecting and licensing intellectual property assets, securing capital resources through financing transactions (debt, equity, strategic partnerships, etc.), and realizing wealth through exit transactions (IPO, stock & asset sales, mergers).

As a transactional lawyer, Philip has handled a full range of complex business transactions, including:

- \$45 million asset sale of animal vaccine products business
- \$1.0 million asset sale of precision surgical instruments business
- \$2.0 million stock sale (plus royalties) of citrus oil products business
- Acquisition of intellectual property portfolio from Russian space agency to commercialize a mass immunization device for animal and human health applications, followed by private placement of \$5.0 million of debt and equity securities to fund research and development and world-wide strategic business development opportunities
- Private placement of \$2.5 million of equity securities to fund software development company
- Private placement of \$1.2 million of debt securities to fund neo-natal medical device company
- Private placement of \$500,000 of equity securities to fund start-up company with patented process for producing recombinant proteins
- Public offering of \$200 million of debt securities for publicly-held transportation company
- Public offering of \$400 million of collateralized mortgage obligations for publicly-held financial institution

Philip has been a frequent author and lecturer throughout his career, including:

- Business Law editor for *The Courts Bulletin* (Missouri Bar, monthly), reviewing all Missouri court business law decisions and then publishing a summary of significant decisions
- Author of "Limited Liability Partnerships," *Specialized Business Entities*, chapter 6 (Missouri Bar 2006)
- Drafter of Missouri Limited Liability Partnership Act (adopted in the Missouri General Assembly as part of House Bill No. 558 in 1995)
- "How to Advise Business Clients on Choice of Entity, Formation & Liability Concerns," Stepping Up & Stepping Out: The New Lawyer Experience (Missouri Bar Seminar 2010)
- Annual Business Law Institute (Missouri Bar Seminar), moderator (2006), "Maintaining the Corporation" (2000, 1997), "Missouri Limited Liability Partnership Act" (1995)

- “Entrepreneurs: You Can’t Afford Legal Issues,” Kansas City Entrepreneurs Club (1995)
- “Nuts and Bolts of Capital Formation: How Do You Get It and What Does It Cost,” Energizing Entrepreneurs: 1994 Entrepreneurship Expo and Workshops (Kauffman Foundation 1994)

Philip’s current civic and community activities include:

- Harriman Council and Board of Advisors to the Harriman-Jewell Series of William Jewell College
- Board of Directors for Kansas City Chamber Orchestra

Philip is highly energized by students of all levels and ages who are seeking to establish their knowledge-base for pursuing their own dreams and ambitions. As an Adjunct Professor of Law for the UMKC School of Law, Philip appears frequently as a guest lecturer and teaches a class in “Advising Life Sciences and Technology Entrepreneurs—The Legal Life Cycles of a High-Growth Venture: Birth (Formation) to Death (Exit).” He mentors recent law school graduates as they develop their own law practices, and also law school and other graduate and undergraduate students as they develop their post-education career and business plans. As an Entrepreneur-In-Residence for the UMKC Regnier Institute for Entrepreneurship and Innovation at the Henry W. Bloch School of Management, Philip interacts directly with students who are already working to establish their own entrepreneurial ventures, helping them to identify and address their own specific legal challenges, while at the same time contributing to their educational experience in the classrooms and also developing practical, solutions-based reference materials to address start-up company challenges.

Philip received his law degree from Vanderbilt University in 1983 and his bachelor’s degree *summa cum laude* in English and business administration from William Jewell College in 1980. He resides in the Kansas City area, and maintains his private law office in Kansas City’s historic River Market district. He is an avid bike-rider, averaging about 50 to 100 miles per week in fair weather, and enjoys reading from his growing collection of presidential biographies.

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