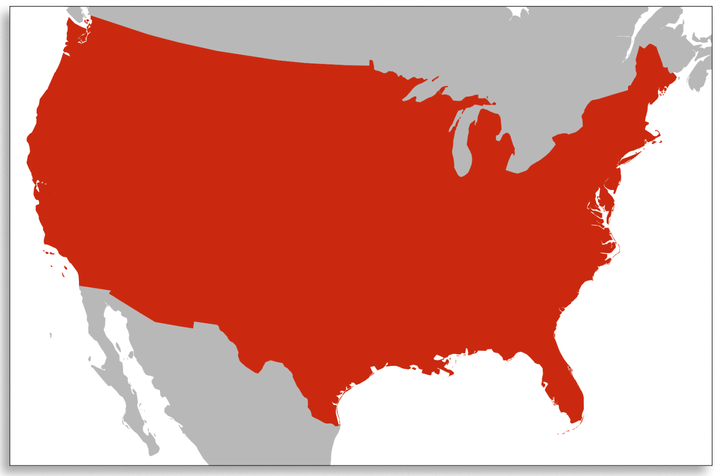
Market Entry: Raising Venture Capital Money in the United States

OVERVIEW

The United States provides a huge percentage of the venture capital invested in startup companies worldwide—the greatest part in Silicon Valley, with smaller percentages in New York and Boston.

Entrepreneurs from all over the world want to raise money from U.S. venture capital funds and strategic investors, partly because of the abundance of funds available, but also because of the important validating effect of being funded and supported by sophisticated and experienced venture capitalists.

This Market Entry Brief will describe the key legal aspects confronting international entrepreneurs and startup companies when they consider raising funds in the United States.



PRELIMINARY CONSIDERATIONS

The most important focus for startups is the familiar list of fundamentals: good technology, a good business plan, a strong management team, a credible revenue model and a lucrative and realistic exit strategy.

International entrepreneurs face additional challenges and opportunities: a more diverse source of funding; international tax structuring; often a less-saturated market for their products and other offerings; and first-mover advantage in less-developed economies.

Venture capital in the United States is a mature industry. The venture capitalists themselves have often been in the business for 30 or more years and have seen tens of thousands of business plans. The competition for top-quality venture capital is stiff. International entrepreneurs must be at the top of their games.

INTERNATIONAL ENTREPRENEURS

Even as recently as 10 years ago it was a common joke that venture capitalists, or VCs, would only invest in companies they could reach in a half-hour drive in their BMWs. Although this is no longer true—all the top VCs have international interests and capabilities—it is still true that many VCs want to have immediate and frequent access to management and to attend board meetings in person.

If international entrepreneurs want to raise money from VCs based in Silicon Valley, therefore, they may be in a stronger position if they and their key people are based in Silicon Valley, or at least spend a great deal of time there. At the same time, international VCs will understand that founders need to be where the core talent is, and often where the target market is located.

U.S.-based VCs will also focus on the ownership and location of intellectual property, international tax structuring, and the possibility of an IPO on a market outside the United States.

INTERNATIONAL STRUCTURE

The most important things from the VCs' point of view regarding the international structure of a startup are:

- Corporate law and comfort with the legal system of the startup's home country
- Comfort with the home country legal system's ability to protect intellectual property

- Accessibility to exits, especially public equity capital markets (taking a Malaysian company public in the U.S. is more difficult than taking a British Virgin Islands company public)
- International tax considerations, particularly with regard to licensing of intellectual property and transfer taxes

U.S.-based VCs are quite comfortable with some non-U.S. jurisdictions, including Israel, much of Europe, and Hong Kong. They are also comfortable with offshore holding company structures, including those using the British Virgin Islands, the Cayman Islands and Ireland.

Most U.S.-based VCs are less comfortable with countries such as the PRC, the South Asian countries and some Latin American countries. If a startup must base itself in one of these countries, the entrepreneurs should consider focusing on dedicated international and emerging-market venture capital funds, including the International Finance Corporation and many of the corporate venture funds maintained by large technology companies.

IMMIGRATION

If a non-U.S. entrepreneur feels a need to spend extended periods of time in the U.S., the question of a non-immigrant visa must be faced. Frequently the "L-1" visa program is used in these cases.

The L-1 visa is available for management and technical personnel who are sent to a U.S. affiliate of a foreign company. The program was originally established in 1970 to permit multinationals to assign non-U.S. managers and technical personnel from their overseas operations to U.S. locations.

Now, the L-1 program is also used by entrepreneurs who have already established a company in their home country, and who are willing to establish a U.S. subsidiary—or to invert their structures so that a new U.S. company becomes the parent of the home country entity. The entrepreneur can then be "assigned" to the U.S. entity for a total of seven years in the case of management, and five years in the case of technical personnel.

Of course this requires the formation of a U.S. corporation.

FORMATION OF A U.S. COMPANY

The basic corporate form in the United States is the "corporation," designated by the letters "Inc." or "Co." after the company name. Corporations have shareholders, whose liability is limited to their investment in the entities. Corporations are chartered by the individual states, so we speak of a "Delaware corporation" or a "California corporation," not a "U.S. corporation."

Corporations are taxed on their net income, at both the federal and state levels. Unlike in many countries, dividends are taxed a second time, as income to the shareholder when received.

Formation of a corporation in any U.S. state is simple, but some states have more efficient departments of corporation than others. A common choice is Delaware, which has a well-understood corporation law and a very smooth-functioning corporate licensing office.

In most cases, a new corporation can be formed in a matter of days. There can be one or more shareholders. There is no residency or citizenship requirement for shareholders, or for directors or officers. There is no concept of a "legal representative" in U.S. corporations; the most important officer, who is presumed to be able to act in all cases for the corporation, is the President or the Chief Executive Officer. The officers answer to the Board. The Board answers to the shareholders.

There is no minimum capitalization set by law, but the corporation should be capitalized to an extent sufficient to meet its obligations.

There may be many different classes of stock, and series within classes, each with different rights. This gives entrepreneurs and investors a great deal of flexibility to arrange different levels of control and economic interest in U.S.-based startups.

FUNDRAISING PROCESS

Once an entrepreneur has attracted the attention of a VC, the discussions will quickly lead to a "Term Sheet." This is a short document, generally in a standard form, which sets out the major terms of the proposed investment. The terms are outlined below.

The Term Sheet is usually not binding on the parties although some VCs will attempt to "lock up" the potential investee. However, once the Term Sheet is accepted and signed, it is unusual for either party to "shop around" without first breaking off discussions.

Once the Term Sheet is agreed to, the VC will engage in careful due diligence of the international company. The more the company's affairs are organized and in good order, the more smoothly this process will go.

The definitive documents for the investment are in customary form, but require careful attention to ensure the Term Sheet provisions are accurately reflected.

A typical venture capital investment might take two months from Term Sheet to closing.

Often there is more than one VC in a round of financing, and frequently there are multiple closings in a round.

CONVERTIBLE NOTES

Startups raising a relatively small amount of money—under U.S.$500,000 in 2013—often issue convertible notes to their investors rather than preferred stock. The notes convert into shares of preferred stock at the next financing, usually at a discount to the price paid by the investors in that round.

CUSTOMARY TERMS OF VC FINANCINGS

Venture capital funds will typically look for the following in any investment:

- Assurance that the founders will stay with the company by imposing a vesting schedule on shares already held by the founders
- A liquidation preference of 1X to 2X—this ensures that upon a "liquidity event" (the sale of the company or a public offering) the investors have the right to receive their money or a multiple of their money before anyone else. Sometimes the investor is required to choose between this preferential return and participating on the same basis as the common stockholders; other times the investors bargain for the right to participate along with the common stock after receiving the preferential return.
- Anti-dilution rights, so that a later issuance at a lower price does not adversely impact the investors. Sometimes this is called "price protection."
- Board representation
- Voting protection on key issues
- Registration rights
- Rights of first refusal, to permit the investors to participate along with new investors in future rounds of financing
- Tag-along rights to permit investors to sell alongside founders or other investors

It is not common in the U.S. for investors to have a "put right"—a right to require the company to buy back their shares.

SERIES PREFERRED

Venture capital investments into U.S. companies are invariably into "preferred stock" of the companies. "Preferred stock" is defined as any stock which has characteristics different from common stock. In VC financings, it means stock which has the preferential rights noted in the bullets above.

Companies can create as many types of preferred stock, and as much of it, as the market will bear. Typically a new "series" of preferred stock is created for each round of financing—thus, Series A, Series B, Series C, etc.

If a company is doing well, the price for each series is higher than the one before. If the company is doing poorly, later series will be cheaper—this is called a "down round."

The Series Preferred stock is invariably convertible into common stock at the election of the investor or upon certain events, such as an IPO. The conversion ratio is generally set at 1:1 at the time of the financing, and adjusted over time to prevent dilution in the case of lower-priced issuances.

SECURITIES LAW COMPLIANCE

Any issuance of stock or other securities to persons in the U.S. requires either registration with the U.S. Securities and Exchange Commission, or an exemption from registration. The most important exemptions for international startups are:

- Regulation D, which permits the offer and sale of securities to "accredited investors" (higher net-worth individuals and entities); and
- Regulation S, which permits the offer and sale to investors outside the United States

There are also state securities laws which must be complied with.

It is very important to document your compliance with these securities laws because later-round investors will insist on a clear record of compliance as a condition to future investments.

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