IPO your start-up

SHAHRAM SAFAI OF LAW FIRM AFRIDI & ANGELL EXPLAINS THE PROCESS OF TAKING YOUR START-UP PUBLIC

A **start-up venture** usually aims to be partially or fully sold or to go public in order to monetise the hard work of the founders and the employees over the years.

Increasingly start-ups dream of and plan to go public in an IPO (initial public offering of shares in a stock market). A recent example is the Facebook IPO. From a business perspective, the start-up will have to achieve a certain amount of business success and, generally, have revenues to make it marketable to investors in public markets.

In order to position a start-up to go public, strategy and proper legal planning is required early on. Two of the most important legal rights that must be addressed for a start-up going public are conversion rights and registration rights.

CONVERSION RIGHTS

Holders of preferred shares (shares that have superior rights to ordinary, common shares) in venture capital deals normally have the right to convert their preferred shares into common shares at any time.

The ratio at which preferred shares are converted into common shares is typically determined by dividing the initial purchase price of the preferred shares by a number called the conversion price, which is adjusted upon certain events. Initially, the conversion price is equal to the purchase price of the preferred shares, so the preferred shares convert into common shares on a one-to-one basis.

Also, the preferred shares usually are automatically converted into common shares upon certain events. Many times, these events are an initial public offering that meets certain criteria. Generally, the start-up company would like the preferred shares to convert as soon as possible to eliminate its special rights and to clean up the balance sheet for the initial public offering.

The criteria for triggering automatic conversion on an initial public offering generally include the following:

1. The offering must be firmly underwritten (i.e., the underwriters must have committed to placing the entire offering, rather than adopting the best efforts approach common in penny shares offerings).
2. the offering must raise a certain amount of money for the company.
3. (Often) the offering price must be at a certain minimum (e.g., four times the conversion price of the preferred shares).

Also, an affirmative vote of a majority or a supermajority of the preferred shares can be used to force an automatic conversion of all of the preferred shares.

Upon any conversion of the preferred shares, the rights associated with it (i.e., liquidation preference, dividend preference, protection, special voting rights, and redemption provisions) cease to exist. Some contractual rights, such as registration rights (the right to force the company to register the holder's shares), usually survive, although others, such as information rights (the right to certain ongoing financial information about the company) and preemptive rights (the right to buy shares issued by the company), often will terminate upon an initial public offering.

REGISTRATION RIGHTS

Investors devote a fair amount of discussion to the subject of registration rights. A registration right is the right to force the company to register the holder's shares with the applicable securities commission so that it can be sold in the public markets.

Often when a company goes public, the underwriters are unwilling to permit existing shareholders to sell in the offering, as such sale will adversely affect the marketing of the new issuance of shares being sold by the company to raise capital. If the shareholder has held the shares for more than one year and the company is public, the holder may be able to sell a limited amount of shares.

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There are several types of registration rights that venture investors are likely to request, two of the most important being: demand rights, and piggyback rights.

A demand right is a right to demand that the company file a registration statement to sell the holder's shares. This is the form the company uses for an initial public offering; it requires a prospectus with extensive information about the company and the offering. A company generally will want to limit this right as it can be expensive and time-consuming, and can adversely affect the company's own capital-raising plans. Generally, the investor group will receive only one or two demand rights, with limits on when they can be exercised.

A piggyback right is the right to participate in an offering initiated by the company. Piggyback rights are generally subject to a cutback or elimination by the offering's underwriter, who may determine, based on market conditions, that a sale by shareholders will adversely affect the company's capital-raising effort. The venture capitalist will seek rights that may not be completely cut back except in connection with the company's initial public offering. Piggyback rights granted to venture capitalists are generally unlimited in number but often expire five to seven years after the company's initial public offering or after a certain percentage of the venture investors have sold their shares.

IPOing your start-up is a worthwhile goal. However, it requires hard work, strategic planning and careful drafting of legal rights in order to provide the appropriate platform for success.

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