CLIENT NOTE

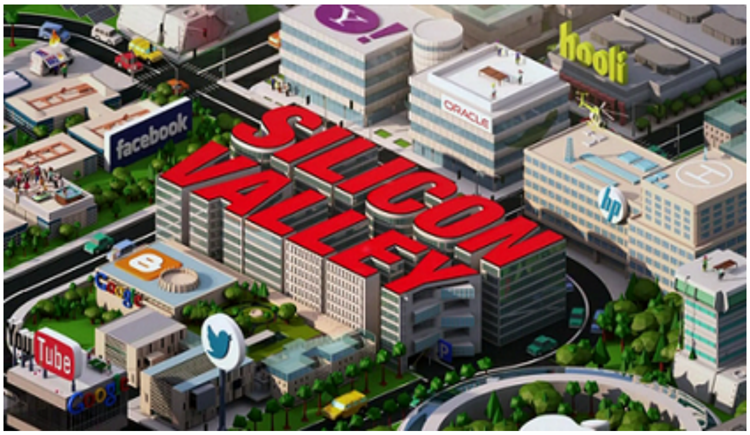
FINANCING OF STARTUPS AND POSSIBLE TENSION BETWEEN FOUNDERS AND INVESTORS

VENTURE CAPITAL INDUSTRY

During the past decade or so there has been a buzz about startups and funding of creative entrepreneurship. What does this really mean? Where is a prime destination? What tensions may arise from external funding and how those may be resolved? How can Armenian entrepreneurs benefit from these developments?

Venture capital has enabled the United States to support its entrepreneurial talent by turning ideas and basic research into products and services that are the envy of the world. The U.S. venture industry provides the capital to create some of the most innovative and successful companies. Many of the firms that have recently raised large pools of capital also have their geographic location in common: California. This, coupled with the relocation of some east coast firms to the west coast, has corresponded to a geographic concentration of capital managed by venture firms.

California firms managed 51% of the nationwide capital recent year. When it comes to innovation companies, Silicon Valley is the most attractive destination of all. It has established itself as an epicenter of substantial capital funding for qualified business ideas. If your startup is really exciting, it's easier to attract local talent pools, partners, legal counselors, and venture capitalists who are willing to bet on your tech company. Local laws play an important role in supporting businesses. Silicon Valley has efficient laws, policies, and regulations to safeguard business interests, trade secrets, and ownership of ideas. These act as a necessary shield for tech businesses, especially the ones that are starting small.



So, imagine you had a great idea, you started your own start up, what are the next steps? How are you going to find financial resources to fund your emerging company?

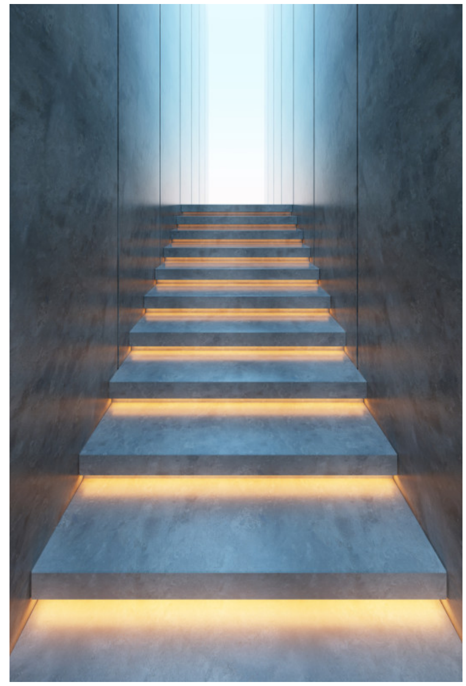
If your business plan has a long-term growth potential and you do not have your own money to fund the entire business, or even any of the business, venture capital may be a great option for you to consider.

Venture capital firms are professional, institutional managers of risk capital that enable and support the most innovative and promising companies. A venture capitalist's competitive advantage is the expertise and guidance they provide to the entrepreneurs in their portfolio. Venture capital is quite unique as an institutional investor asset class. Venture capital funds make equity investments in a company whose stock is essentially illiquid and worthless until a company matures five to eight years down the road. Follow-on investment provides additional funding as the company grows. These "rounds," typically occurring every year or two, are also based on equity in the company, with the shares allocated among the investors and management team based on an agreed "valuation." However, unless a company is acquired or goes public, there is little actual value. Venture capital is a long-term investment.

ROUNDS OF STARTUP FINANCING

There are five distinct stages of venture capital funding: start-up stage, seed or early stage, growth stage, late stage, and buyouts/recapitalizations.

Start-up Stage: Newly formed companies without significant operating histories are considered to be in the start-up stage. Most entrepreneurs fund this stage of a company's development with their own funds as well as investments from angel investors. Angels are wealthy individuals, friends, or family members that personally invest in a company.



Seed or Early Stage: This round often involves investments of less than $5 million for companies that have promising concepts validated by key customers but have not yet achieved cash flow break-even. Organized groups of angel investors as well as early stage venture capital funds usually provide these types of investments.

Growth Stage: Growth stage investments focus on companies that have a proven business model and either are already profitable or offer a clear path to sustainable profitability. These investments tend to be in the $5-20 million range and are intended to help the company increase its market penetration significantly.

Late Stage: Late stage venture capital investments tend to be for relatively mature, profitable companies seeking to raise $10+ million for significant strategic initiatives (i.e. investment in sales & marketing, expansion overseas, major infrastructure build-outs, strategic acquisitions, etc.) that will create major advantages over their competition. These opportunities are usually funded by syndicates of well-established venture capital firms who manage large funds.

Buyouts and Recapitalizations: Buyouts and recapitalizations are becoming more prevalent for mature technology companies that are stable and profitable. In these transactions, existing shareholders sell some or all of their shares to a venture capital firm in return for cash. These venture capital firms may also provide additional capital to fuel growth in conjunction with an exit for some or all of the company's existing shareholders.

Once successful portfolio startups mature, venture funds generally exit their positions in those companies by taking them public through an initial public offering (IPO) or by selling them to presumably larger entities (via an acquisition, merger, or trade sale) or to a financial buyer (e.g., a private equity buyer). This exit in the company allows the venture firm to distribute the proceeds to investors, raise a new fund for future investment, and invest in the next generation of companies.

TENSION BETWEEN FOUNDERS AND INVESTORS (VENTURE CAPITAL FIRMS)

Even with a lot of advantages that you can enjoy while cooperating with Venture Capital firms, there are also some disadvantages to consider before you dive into this method. There is always tension between founders and Investors over governance issues.

When raising a funding round, you will need to dilute your equity to issue new shares to your investors. Many companies outgrow their initial funding and have to raise additional rounds from venture capital firms. This process results in founders losing the majority ownership in their company and with it, the

control and decision-making power that comes with being a majority shareholder. As a result, if your vision changes or is different from that of your investors, it may cause problems down the road. VC with less than 50% ownership of a company (which is often the case) does not necessarily mean they have no control in your firm. If you are not careful, even if they do not own more than you, they could run away with the company, especially if they are aggressive. You will want to keep as much of the company as you can and stand your ground if they start to completely change the direction of your company. Moreover, if the firm or investor decides that they need a large portion of your company—50% or more—you could become a minority owner. This means that you would no longer own your company completely and you would not have the final say in any matters.

The ability of a venture capitalist to enforce a decision and gain control over the company is dependent on numerous factors, and especially the investment contract. The structure of the investment contract is critical, as it can determine the future relationship with your investor. First-time entrepreneurs are at an enormous disadvantage, in terms of experience, in negotiating against sophisticated, repeat players of the field. This is when the lawyers come into play.

HOW WE CAN ASSIST?

Our team of lawyers provide valuable legal advice and strategy to clients at every stage of the fund lifecycle. With a thorough knowledge of the global regulatory framework trends we draft and close venture deals. We have seen far more deals than many of the entrepreneurs and have the ability to help you to level the playing field by using our expertise and skills in negotiating deals and managing high-stakes governance issues for startups. The small details can mean the difference between a successful deal or not.

So, if you have a startup and want to raise money thorough venture capital, we would love to assist you in structuring and negotiating financing arrangements ranging from seed stage to late stage equity investments in and outside of Armenia.

NOTE: This material is for general information only and is not intended to provide legal advice

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