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## ARTICLES

- The Limitations of Limited Liability:  
Lessons for Entrepreneurs (And Their Attorneys)
- John H. Matheson* 1
- Venture Capitalism After the Burst of the internet  
Bubble:  
Selecting Financing Terms With Care
- Joseph L. Lemon* 11
- Sarbanes-Oxley: Its Impact on the Venture Capital  
Community
- John Dexheimer*  
*Carla Haugen* 31

## KOMMERSTAD CENTER SPEAKERS FORUM

- Achieving Goals
- Randy Kominsky* 39

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## THE LIMITATIONS OF LIMITED LIABILITY: LESSONS FOR ENTREPRENEURS (AND THEIR ATTORNEYS)

JOHN H. MATHESON \*

An entrepreneur does not start a new business expecting it to fail. Yet, according to various statistics, most independent start-up businesses fail within the first year, while as many as 90% are no longer in business after three years. This is why the issue of personal liability for the owners of the business is critical.

Historically, the entrepreneur could protect personal assets by forming and operating the business as a corporation, recognized by state law as a legal entity separate from the owner of the business for purposes of imposing liability. Although operating a business as a corporation presumptively shields the personal assets of the owners from the claims of the business's creditors, a creditor may ask a court to ignore this liability shield when the corporation is unable to pay its debts and goes bankrupt. Disregarding or "piercing" the statutory limited-liability shield permits the business debts to be satisfied out of the owner's personal assets. Absent a judicial decision to "pierce the corporate veil" in this manner, the limited liability created by the applicable corporate statute stays intact and the creditor must shoulder the loss.

It is crucial that entrepreneurs and the attorneys advising them do everything possible to avoid potential "piercing." However, there are no clear guidelines for this task. Writing in a piercing case in 1926, one of the great judges of the common law, Benjamin Cardozo, wrote that "[t]he whole problem of the relation between [owners and their] corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."<sup>1</sup> Metaphors provide little guidance to entrepreneurs and their attorneys about what will result in a loss of limited liability.

Sixty years later Robert Clark, renowned corporate scholar and Harvard Law School Dean, commented: "Do you notice anything intellectually disturbing about this [standard piercing-the-veil] formulation? That's right; IT'S vague. It hardly gives you any concrete idea about which conduct does or does not trigger the doctrine--not enough of an idea, at least, to give you the ability to counsel clients in a meaningful way."<sup>2</sup>

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<sup>1</sup> Berkey v. Third Ave. Ry., 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.).

<sup>2</sup> Robert Charles Clark, Corporate Law 38 (1986).

Now that presumptive limited liability for business owners has become the norm through the proliferation of new forms of limited liability entities (LLEs) such as the limited liability partnership and the limited liability company, the stakes are more significant than ever. New forms of business organizations as well as corporations must address the issue of when limited liability might be lost.

The start-up business owner and the attorney counselor must prepare for the possibility that the business may fail. Creditors of the business may ask the court to ignore the separate legal existence of the LLEs and impose personal liability on the owner. It appears that the courts will follow the same general procedure for piercing the veil of the more modern LLEs based on the standards that have been historically applied to pierce the corporate veil of the corporation.<sup>3</sup> The purpose of this article is to describe these standards and to distill some basic, practical lessons that entrepreneurs and their attorneys can follow to lessen the disastrous potentiality of piercing.

American law governing corporate limited liability has had a contentious history. In the 1800s, Thomas Cooper described limited liability as a "mode of swindling, quite common and honourable in these United States" and "a fraud on the honest and confiding part of the public."<sup>4</sup> Early in the twentieth century, President Butler of Columbia University acclaimed limited liability as "the greatest single discovery of modern times" and that "even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it."<sup>5</sup>

Until the early to mid-1800s, legislation in both England and the United States imposed strict limits on an owner's ability to incorporate and to receive the benefits of limited liability. Incorporation required a special act of Parliament or a state legislature. State legislatures enacting general corporation statutes usually imposed substantial limitations on corporations,

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<sup>3</sup> Colorado, Minnesota, and Texas Limited Liability Company statutes expressly allow "piercing" law developed for corporations to be applied to new LLE forms. Colo. Rev. Stat. Ann. § 7-80-107(1); Minn. Stat. Ann. § 322B.303 subd. 2; Tex. Rev. Civ. Stat. Ann. art. 1528n. For examples of cases applying corporate piercing tests to new forms of limited liability entities, see *Gallinger v. North Star Hosp. Mut. Assurance, Ltd.*, 64 F.3d 422, 427-28 (8th Cir. 1995); *Middlemist v. BDO Seidman, LLP*, 958 P.2d 486, 491 (Colo. Ct. App. 1997); *Hollowell v. Orleans Reg'l Hosp.*, No. Civ. A. 95-4029, 1998 WL 283298 (E.D. La. May 29, 1998); *Abu-Nassar v. Elders Futures, Inc.*, No. 88 Civ. 7906 (PKL), 1991 WL 45062, at \*10-14 (S.D.N.Y. Mar. 28, 1991).

<sup>4</sup> Herbert Hovenkamp, *Enterprise and American Law 1836-1937*, at 50 (1991) (quoting Thomas Cooper, *Lectures on the Elements of Political Economy* 247, 250 (2d ed. 1830)) (footnote omitted).

<sup>5</sup> Stephen B. Presser, *Piercing the Corporate Veil* §1.01, at 1-5 (1999) (citation omitted).

including minimum paid-in capital requirements, limited permissible purposes, and limited duration. As corporations began to dominate the economic landscape, however, legislatures removed nearly all the original limitations on the ability of corporations to organize and operate.

Following the Industrial Revolution, capital-intensive businesses required substantial expenditures beyond the means of the typical entrepreneur, requiring outside investment. Granting limited liability to those who contributed capital encouraged investment because people could invest without risking their full personal net worth. Developing modern capital markets depended on limited liability. Although investors may be willing to risk their entire net worth in businesses they themselves operate, they are not willing--absent limited liability--to invest in businesses that they do not operate or closely oversee. Limited liability enabled venture capitalists and casual investors to invest in diverse enterprises without incurring the excessive costs necessary to monitor each enterprise closely.

Today these purposes have broadened. While corporate limited liability promoted passive investment, new LLE forms, such as the limited liability partnership and limited liability company, expect owner involvement in running the business. Legislatures' purposes have expanded from merely encouraging and protecting passive investors to simply and actively promoting business.

To provide guidance on when the owner of an LLE will lose the benefit of limited liability, the place to start should be with the courts' experiences over the years dealing with this issue in the corporate context. This is not as helpful as one might think -- the "tests" used by courts to determine whether to pierce the limited liability veil are universally recognized as unhelpful.<sup>6</sup> The courts employ at least three conclusory "tests":

***The Agency Test.*** Plaintiffs must show that the owner exercised a significant degree of control over the corporation's decision making;

***The Alter Ego Test*** (founded in equity). The court will pierce the corporate veil to prevent fraud, illegality; or injustice, or when recognition of the corporate entity would defeat public policy or shield someone from liability from a crime; and

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<sup>6</sup> See, e.g., Phillip I. Blumberg, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* 8 (1983) (suggesting that court decisions are "irreconcilable and not entirely comprehensible"); Clark, *supra* note 2, at 72 ("[T]he courts usually forgo any sustained attempt at a remedial theory or even a coherent exposition of the basis of liability, although descriptive summaries are occasionally attempted."); Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* 54-55 (1984) ("[T]ests used by courts--whether a corporation has a 'separate mind of its own,' whether it is a 'mere instrumentality,' and so forth--are singularly unhelpful.").

*The Instrumentality Test.* Plaintiffs must show that the parent exercises extensive control over the acts of the subsidiary giving rise to the claim of wrongdoing.<sup>7</sup>

Application of these tests often consists largely of lists that the courts recite with little analysis or justification. Some courts list as many as nineteen factors.<sup>8</sup> A sample list from one court recites “insufficient capitalization for purposes of corporate undertaking, failure to observe corporate formalities, nonpayment of dividends, insolvency of debtor corporation at time of transaction in question, siphoning of funds by dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and existence of corporation as merely a façade for individual dealings.” According to that court, an unspecified number of these factors, combined with an element of “injustice or fundamental unfairness,” would justify disregarding the corporation and holding the owners liable.<sup>9</sup>

At best, these “totality of the circumstances” analyses are a case-by-case assessment of the equities of each individual situation. At worst, they impose onerous burdens on an owner whose only culpability is the failure of the business. Nevertheless, a careful study of the cases provides an outline of principles that may provide guidance for the business owner. While no entrepreneur can prevent absolutely the ultimate imposition of personal liability by a court once the business fails, several steps should be standard operating procedure or standard advice by attorneys for the start-up business.

#### LESSON ONE: GET IT DONE

In an earlier issue of this Journal, I described and discussed the various alternative forms of limited liability entities available for use by today’s start-up business owner.<sup>10</sup> While there are various benefits and drawbacks to each of these business organizational forms, they all have one thing in common. They exist only when a fee is paid to file signed documentation with a state agency - usually the secretary of state or department of commerce. If no filing occurs, no LLE exists, and the personal assets of the business owner are totally unprotected. Therefore, the first lesson for the entrepreneur in seeking to avoid personal financial ruin is to get the LLE of choice formed. GET IT DONE!

Entrepreneurs understandably focus on the business of getting the business going. This usually means designing and developing the product or

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<sup>7</sup> Richard v. Bell Atlantic Corp., 946 F. Supp. 54, 61 (D.D.C. 1996).

<sup>8</sup> Laya v. Erin Homes, Inc., 352 S.E.2d 93, 98-99 (W. Va. 1986) (listing 19 factors).

<sup>9</sup> Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979).

<sup>10</sup> John Matheson, Choice of Organizational Form for the Start-Up Business, Minn. J. Bus. Law & Entrep.

service; assembling appropriate management, operational and sales personnel or teams; identifying and raising financial resources; and developing and implementing a marketing strategy. Too often, the demands of these important and necessary business activities take priority over “legal formalities,” and the legal formation of the LLE gets lost in the business demands of the moment. This is a big mistake. There is no protection for personal assets until legal formation of the LLE -- timing is everything.

If a business owner signs a contract for the business on Monday and forms the LLE later in the day, the business owner is personally liable on the contract. Similarly, if on Monday, an employee of the business drives carelessly while running a business errand, injuring a pedestrian, and the LLE is formed on Tuesday, the owner is personally liable for the employee’s negligence. Reverse the order of events in either of these scenarios, and the business owner’s personal assets are presumptively safe from appropriation for the business debts.

Intending to look into those “legal” issues, intending to meet with counsel, intending to sign the documents and return them, or intending to send the fee check and the papers to the state office, are to no avail. One can pave the road to ruin with good intentions.

As a practical matter, formation of the LLE is simple and involves minimal paperwork and fees. There is no excuse for not getting it done. There is even less excuse for the business’ legal counsel not getting it done.

Even if there are thorny ownership, allocation, or transfer issues to work out, the basic formation of the limited liability entity should be completed even before these issues are resolved. Courts have little sympathy for entrepreneurs who do not “get it done.”

Under the doctrines of “de facto incorporation” or “corporation by estoppel,” courts in some circumstances have come to the rescue of the entrepreneur by allowing for limited liability even where formation of a corporation was incomplete. This judicial solicitude cannot be relied upon. Whether and to what extent these theories will extend to other putative LLE formation situations is yet to be seen.

## LESSON TWO: PLAY THE GAME

Once the courts have looked at the LLE formation, the issue of piercing becomes the focus. One of the most striking aspects of the lists of factors the courts employ to make a piercing determination is the emphasis on organizational formalities. To review the list set forth earlier: “insufficient capitalization for purposes of corporate undertaking, failure to observe corporate formalities, nonpayment of dividends, insolvency of debtor

corporation at time of transaction in question, siphoning of funds by dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and existence of corporation as merely a façade for individual dealings.” Half of this list concerns following formal procedures or allowing participants in the LLE to play their roles. These are matters of form, not substance.

After formation of the LLE, laws require certain organizational steps. For the corporation, these steps include holding an organizational meeting of the incorporator to elect directors, adopt bylaws, elect officers, adopt banking resolutions, adopt a fiscal year, accept subscriptions for issuance of shares, hiring employees, make tax elections, and authorize or ratify the purchase, lease or other acquisition of suitable space, furnishings, equipment and supplies.

It may seem silly to the owner of a one-owner LLE to hold a meeting with him or herself as incorporator and then as the sole member of the company’s board of directors, and then another meeting to take actions as the sole shareholder. Yet this is what the courts expect because this is the appropriate manner in which the corporation -- as distinguished from the business owner -- is understood to operate.

Beyond the initial organizational activities, directors and shareholders should hold regular meetings, and officers or other employees should fill their roles and take actions within their designated authority. These steps will seem unnecessary to the business owner, but they will keep the courts from finding an easy way to criticize the entrepreneur for failing to follow corporate formalities. Why give the courts a wedge to begin the process of piercing the LLE veil?

Maybe it is easier to think of the limited liability granted by formation of an LLE as an insurance policy. As with any insurance, the policy does not go into effect until the policy is issued and the insured pays the first premium. In the LLE context, the entrepreneur buys the initial insurance of limited liability by forming the LLE. But as with all insurance policies, there are subsequent premiums to pay. The subsequent premiums in the LLE context are observing the requisite formalities of its operation—holding meetings, maintaining separate books and records for the entity, and having the LLE personnel function in their designated roles. Failure to follow these expected formalities, like failure to pay the premiums on any insurance policy, may cause the insurance to lapse. For a business owner this may mean piercing the LLE veil with the attendant imposition of personal liability for the business debts.

Following expected LLE formalities -- playing the game -- is a small price for the entrepreneur to pay to keep the insurance of limited liability in force. Observance of LLE formalities need not be burdensome. Many necessary LLE

actions can be accomplished without a meeting by way of written documentation distributed and signed by the appropriate LLE actors.

Here the entrepreneur's attorney can be extremely helpful. Legal counsel for the business should remind and assist the business owner to observe these formalities. Counsel knows what the courts expect and can help assure that the business observes the requisite formalities. It is important, then, for legal counsel to act and for the business owner to accept the acts of legal counsel as an important partner in protecting the owner's assets.

### LESSON THREE: THERE IS ONLY "YOURS" AND "MINE" -- THERE IS NO "OURS"

It is not easy for anyone to keep one's personal financial life organized. Even in the everyday matters of bills and bank accounts and credit cards and other obligations, things can get lost or items mailed to the wrong party. For the start-up businessperson, adding the new LLE as a separate financial person to his or her life complicates these challenges.

The financial dealings of the LLE must be kept separate from the personal financial matters of the owners. Creating separate bank accounts, separate ordering and billing procedures, separate checks and invoice payment, and separate books of the LLE's financial affairs are a part of that process. This separateness must be maintained religiously. It is no excuse that a business owner does not have the LLE checkbook when called upon to write a check for a business obligation. A personal check or other personal payment is unacceptable. Similarly, LLE checks, LLE funds, or LLE cash or credit to pay or guarantee personal obligations is forbidden. In the law of piercing the LLE veil, there are the owner's assets and there are the business assets. There are no assets owned jointly by the business and its owner.

For the courts, commingling of assets or funds between the business and the owner is a red flag for potential piercing. Commingling shows that the owner does not recognize or operate the business as a separate legal person. In judicial terms, the LLE appears to be merely a façade for individual dealings.

Second, remember that the issue of piercing usually arises because the business has gone bankrupt. Commingling often signals the courts that there was inadequate capitalization for the business or that the owner has been siphoning off LLE funds. Courts are neither equipped nor interested in delving deeply into the financial transactions and records of the LLE when creditors seek to pierce the LLE veil. They may take even innocent commingling as indicia of more serious financial chicanery and use it as a convenient linchpin to hold the owner personally liable for the debts of the defunct business.

#### LESSON FOUR: TELL THE TRUTH

Entrepreneurs are optimistic salespeople by nature. The business will be a success. They look on the positive side and expect that things will be done. And what will get done is as good as done. You can count on it. What is not yet finished (or maybe not even started) in the formation or operation of the business is thought of as being “in process.”

In the law of piercing there is little room for matters “in process.” It operates in a polar way. The law deals in facts, not optimism or salesmanship. It is or isn’t. You did it or you didn’t. You own it or you don’t. There lies an important lesson in the operation of the start-up business.

Misrepresentation, even when innocent, can play a major role in the jurisprudence of piercing. What the entrepreneur might optimistically report as “good as done” looks like misrepresentation to a court when it is asked to pierce the LLE veil. Owner contributions in the LLE have been paid into the LLE bank account or they haven’t. The LLE owns certain assets or it doesn’t. The business signed that contract with an important distributor or it didn’t. The bank has approved and funded the business loan or it didn’t.

There is no room for sales talk in dealing with the reality of the LLE and its assets and obligations. Entrepreneurs that report matters in process as accomplished court (no pun intended) disaster when later the business fails. It is better in business to report the operational and financial and facts when dealing with creditors and other third parties than to put an optimistic spin on those facts. The alternative invites piercing and personal liability. The entrepreneur’s optimism and sales talk may look like fraud to a court when asked to pierce the LLE veil.

#### LESSON FIVE: GET BUSINESS INSURANCE

Despite the best business idea, the most committed of entrepreneurs with the greatest solicitude for recognizing the separate existence of the business, there may be a business failure. Too late, the entrepreneur realizes he or she should have purchased and maintained business liability insurance.

Business liability insurance may seem a needless expense to the entrepreneur. The business is strapped for cash as it is, and pouring money down this drain may be furthest from the wishes of the business owner. There are good reasons to overcome this reluctance.

The availability of business insurance to pay some of the claims of the defunct business lessens potential exposure of the entrepreneur. Whatever the insurance covers is a debt paid, and no claims will be made against the business owner’s personal assets based on paid debts.

As legal protection, business insurance serves valid purposes. First, it demonstrates that the owner recognized the LLE as a separate person with its own legal obligations and attendant insurance requirements. Second, it shows a court that not all claimants are left without recourse if the LLE veil remains intact. Those covered by the insurance are fully or partially compensated. Those not covered, often voluntary business trade creditors, financial institutions, or other transactional parties, may be left without recourse. These voluntary creditors chose to do business with the LLE with full knowledge of its nature as a start-up business. They could have chosen not to. They could have secured their obligations with a pledge of the assets of the business as security. They could have secured personal guarantees from the owners. They did not, and not having protected themselves from the potential of the business failing, they are not in a particularly appealing posture to call upon the equity of the courts to pierce the LLE veil.

Maintaining business insurance may have an important psychological effect on the court asked to pierce the LLE veil. The business owner was trying to do the right thing and recognized that people who might be harmed by the business should receive compensation. Absent piercing, the fact that voluntary creditors are left without recourse appears more palatable under these circumstances.

#### LESSON SIX: MAKE LEMONADE -- REVERSE PIERCING

According to a common saying, when life serves you lemons, make lemonade. A failed business is a large serving of lemons. The hopes, expectations, and most or all the assets of the entrepreneur are gone. Time to make lemonade.

In the piercing context, making lemonade may mean attempting to secure the best result from the bad situation of the business failure. Are there circumstances when the business owner will be better off if the LLE veil is pierced? This is what courts refer to as "reverse piercing." Although it will be rather rare for a business to ask a court to ignore the very entity he or she created, attempts to accomplish this result have occurred in various contexts with varying success.

Consider the situation where the start-up LLE business is a farm where the owners will live. The owners transfer the farm into the name of the LLE for various business and tax reasons. If the business goes bankrupt, is the farm available to satisfy creditor claims? Presumptively, yes. If the farm were held in the names of the owners themselves, it would be protected by a state constitutional or statutory homestead exemption. In these circumstances, a court may be sympathetic to the plight of the owners, ignore the separate existence of the LLE, and allow the owners to claim the exemption.

Sometimes the reverse pierce theory can be used even if the business does not go bankrupt. Consider a one-owner business where title to six motor vehicles is held in the name of an LLE and are the only vehicles driven by the business owner. If the business owner dies, survivors' benefits under the vehicles' no-fault policies cannot be paid to family members, because the LLE and not the individual was the "insured," and LLEs do not have survivors. A court may reverse pierce and allow the survivors' benefits despite the existence of the LLE.

Even though no entrepreneur goes into business with the thought of reverse piercing in mind, situations may develop and the possibilities should not be overlooked. Lemonade tastes better than lemons.

It is not possible to guarantee the success of any business. Entrepreneurs and their counsel can do much to lessen the potential for piercing the LLE veil. The lessons are easy to implement and the cost is negligible. Careful planning and care in operating the business can avoid making a bad situation of a business failure a worse situation of personal bankruptcy for the business owner.

## Venture Capitalism After the Burst of the Internet Bubble: Selecting Financing Terms With Care

JOSEPH L. LEMON, JR \*

In the three years since the burst of the Internet bubble, the venture capital landscape has changed dramatically. Gone from Silicon Valley are the VC tourists -- latter-day prospectors who flocked to California in an IPO-rush.<sup>1</sup> Gone are the \$100 million valuations of companies that failed to raise any revenue, not to mention any profits. Gone are the days when VC firms and entrepreneurs did not bother to understand the intricacies of their negotiated term sheets, because their portfolio companies went public before the ink dried on the contracts.

VCs left standing are finding that they have more time to evaluate their deals and haggle for the most favorable terms possible. While the marked decline in public offerings has returned the benefit of bargaining power to the VCs, exacting the most demanding terms possible may not be in their best interests. Two elements of traditional VC contracts are problematic -- liquidation preferences and anti-dilution provisions. Although these features aim to protect the upside opportunity and avoid the risk of the VC investment, VCs should steer clear of the most aggressive versions of these provisions.

### *Venture Capital Contracting*

Contracts are most successful when the parties agree on concrete, unwavering terms. While this is usually true in discrete transactions, what happens in contractual relationships extended over many years and exposed to many risks and uncertainties? This is the tempestuous environment in which VCs and entrepreneurs must negotiate the contours of their mutual obligations.

The relationship between a VC and its portfolio company lasts about five years. During this time, the parties may flirt with overwhelming success but live in the shadow of failure. VC investments aim for very high returns. Really

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Note: This article is an abridged version of an article entitled "Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era," which first appeared in *39 Tex. J. Bus. L.* 1 (2003). Please refer to that article for a more thorough discussion of the issues presented here, including additional examples, figures, charts, and citations to other works.

<sup>1</sup> Telephone Interview with Joseph A. Grundfest, W. A. Franke Professor of Law and Business, Stanford Law School (Apr. 5, 2002).

good odds require creative contracting, so the VC industry has responded with dynamic terms to provide flexibility in these relationships and the capability to adjust to new information as it becomes known to the parties.

One often hears that VCs must structure agreements to protect themselves against the risk that entrepreneurs will use superior knowledge of their companies to maximize personal benefits through potentially inefficient means. This assumed disparity in information may be exaggerated for two reasons. First, VCs are often specialists within industries, often investing in multiple companies in the same industry space. They are likely to have both broad and specific knowledge about the company's prospects in these industries.

Second, the entrepreneur's knowledge of the company's prospects may be overstated. It is true that the entrepreneur-manager is privy to the inner workings, personnel, and developments of the individual enterprise. This does not necessarily extend to superior knowledge of the marketplace as a whole. In fact, most VC-funded companies engage in highly speculative activities where prospects for success or failure are more difficult to predict than prospects for traditional industries. Finally, a founder's judgment of a company may be clouded by the unbridled enthusiasm that is a prerequisite for entrepreneurship.

While the presumed information asymmetry between VCs and entrepreneurs may not be the most plausible explanation for the malleability of VC contracts, the duration of the relationships and the mutual uncertainties of the parties do demand flexibility in VC agreements.

The keystone of these agreements is the selection of the funding instrument. In most VC financings, VCs contribute funding in exchange for convertible preferred stock. Preferred stock enjoys rights that its common stock counterpart does not have. These rights may include liquidation preferences, interest dividends, and senior status as a creditor.

Holders of convertible preferred stock may convert the shares into common shares, allowing them to take advantage of the potential financial upside opportunity available to common shareholders. This conversion may occur automatically with predetermined events, or the preferred shareholders may initiate the conversion at their discretion, which may be absolute or contingent on particular events.

Holders of convertible preferred shares have voting rights equal to those of the common shareholders on an "as if converted" basis, allowing this flexible instrument to act as a debt/equity hybrid. Convertible preferred shareholders have a specified return in terms of the interest dividend and the liquidation preference, just like a debt-holder. At the same time, they may have the right to convert these shares to common stock to maximize the return on their investment.

Preferred shares are converted at a predetermined amount -- the per share price paid by the preferred holder. An exception occurs when anti-dilution provisions allow a reduction in the conversion price to preserve the investor's initial percentage of ownership following a conversion of the shares to common stock.

### *Liquidation Preferences*

Liquidation preferences protect VC interests by setting a minimum return for the VC fund before other stakeholders share in the remaining distributions. These preferences are usually a multiple of the initial investment (2x, 3x, etc.). Preferences may be straight and non-participating or participating. With non-participating preferred shares, the investor's preference is limited to the amount in the contract. The investor may elect to receive the predetermined amount or share in the profits by converting the preferred shares to common stock.

Participating preferred shareholders are entitled to the predetermined preference first. Then they also may convert to common stock and take a pro rata share in the remaining profits. The preferences may take on a cumulative effect, as multiple rounds of investors negotiate for a liquidation preference and whittle down the profits available to the common shareholders.

Aggressive liquidation preferences can produce harsh results. Consider the case of a VC \$5 million investment with 5x participating preferred liquidation preference for a 50% share in a company valued at \$10 million "post-money" -- after the most recent infusion of capital. The company could liquidate at five times its original value -- \$50 million -- producing a 750% return for the preferred holders. But this would leave the common shareholders with a disappointing 250% return on their pre-money valuation. Since the appreciation of common stock is the principal means of compensation for founders and key employees, these disparities could lead to significant under-compensation and create disincentives for company management.

The occurrence of specific events triggers liquidation preferences. Common examples of these events are mergers, acquisitions, sales of assets, and IPOs.

### Anti-Dilution Provisions

The basis of a VC's investment in a company is an estimated valuation of the enterprise. However diligent the VC is in determining this valuation, its efforts are limited by incomplete information and potential risks. Unforeseen changes in the company's human capital or technology, competitive imbalances, regulatory changes, alterations in customer preferences, and domestic and international economies may negatively affect the value of a

particular company. If the company requires a new injection of capital, newer rounds of financing will necessitate a reduction in the valuation of existing securities. This revaluation can dilute the ownership of early-round investors.

If a prior-round investor paid \$1 per share and a subsequent investor only pays \$.50 for the same percent of ownership, this reduces the first investor's equity stake. VC firms safeguard against this possibility by negotiating anti-dilution provisions which serve as price protection for the VC. If later-round investments are made at a lower price, the preferred shareholders are granted a reduction in their conversion (from preferred to common stock) price, resulting in a greater distribution of common shares.

Price-protection anti-dilution provisions generally take on two forms. The first is "full ratchet" anti-dilution protection. In this version, the sale of a single share to a subsequent investor at a lower price automatically recalibrates the initial investor's conversion price to the new lower price. For example, if a Series A investor paid \$1 per share for 1 million shares of preferred stock and a Series B investor pays \$.50 for even a single share, all the Series A shares will be entitled to a new conversion price of \$.50. This doubles the equity stake of the Series A investor. As an arbitrary provision, its outcome can be draconian.

Anti-dilution provisions eliminate the temptation to offer more favorable prices to subsequent investors unless a revaluation is warranted and sensible under the circumstances. Unfortunately, the inflexibility of full ratchets places severe limitations on future investments when the company's valuation needs to be adjusted downwards, regardless of how prudent such a revaluation may be without the full ratchet. The full ratchet serves as a poison pill that discourages future investment because, as the purchase is made, it dilutes the equity that a later-round investor was negotiating to buy.

The second group of anti-dilution provisions is based on weighted-average anti-dilution protection. Weighted-average anti-dilution determines the overall effect of the purchase of new shares in a subsequent round and readjusts the earlier-round conversion prices by a proportionate amount. The new conversion price is a function of the old conversion price, the money invested in the current round, the total number of outstanding shares before the current round, and the number of new shares issued in the current round.

If a Series A investor purchased 5 million shares at a per share price of \$1 in a company with 10 million shares and a Series B investor purchased 5 million shares at a per share price of \$.50, then Series A's new conversion price is reduced to \$.833. This new conversion rate mitigates the extent of Series A investor's equity dilution. The original stake was 50%. Without the anti-dilution protection, the ownership would decrease to 33.3%. Because of the protection, the percentage only falls to 37.5%.

Two variants of the weighted-average anti-dilution formula are the narrow-based formula and the broad-based formula. Narrow-based weighted averages exclude stock options from the determination of the number of outstanding shares before the current round of financing. The broad-based formula includes these options in the calculation. The inclusion of the options serves to spread the effect of the dilutive round, mitigating the decrease in the new conversion price.

A right of first refusal entitles an earlier-round investor to participate in the subsequent investments, on a pro rata basis, of that investor's percentage of ownership. Because this right may affect the company's ability to strike deals with employees, consultants, directors, and potential partners, it often excludes the right to participate when such transactions occur.

A final point regarding anti-dilution provisions considers a condition that must be met by earlier-round investors before they benefit from anti-dilution safeguards. This often is referred to as a "pay-to-play" provision. The pay-to-play provision requires investors to contribute their pro rata share of the cost of the dilutive round to be eligible to receive the reduced conversion price. In these cases, failure to participate in the dilutive round typically results in forfeiture of any price protection. The motivation for such provisions is to require continued contribution and participation by all investors, particularly when the company faces financial difficulties or challenges.

### *Liquidation Preferences and Anti-dilution Provisions Matter*

In the robust VC market of the mid to late 1990s, liquidation preferences and anti-dilution provisions were of little effect. Anti-dilution provisions were seldom triggered because the appreciation trajectories of company valuations were always positive and subsequent rounds of investment at higher valuations rendered this form of protection unnecessary.

In that hot market, the value of liquidation preferences was lessened considerably. With non-participating preferences, investors could receive a superior return by converting to common stock rather than relying on the preference. Even participating preferred stock was less of a problem, because liquidations were at such a high valuation that company founders, management, and employees had sufficient profits to share even after the preference was paid to investors. Predetermined preferences in the boom years, if employed at all, ranged from 1 to 3 times the initial investment.

In the new millennium, the landscape has changed, and these two terms have a newfound significance. Not only are VCs applying these provisions for under-performing portfolio companies in which they have already made an investment, they also are employing these terms in their more aggressive forms in new rounds and initial investments in recently added portfolio companies.

The application of the more draconian provisions in VC term sheets for prospective investments are particularly troublesome, because their use undermines the potential success of the portfolio companies. History warns against ignoring prospective companies with bright prospects based solely on a weak economy. Companies such as Palm, Intuit, and McAfee received their first round of venture financing during the last dip in venture financing in the early 1990s.

In a study of more than 200 VC financings, published by the National Bureau of Economic Research, the authors observed the use of liquidation rights in excess of the initial investment in nearly 75% of contracts -- 23.3% provided for liquidation rights equal to the investment and 2.2% allowed for liquidation rights less than the initial investment. They also found a high incidence of the use of anti-dilution provisions -- 19.4% of the sample employed a full-ratchet anti-dilution provision, while 75.4% used a form of weighted-average formula.<sup>2</sup>

Anecdotal examples of severe liquidation preferences in the current economic environment abound. CriticalArc Technologies Inc. recently completed a \$3 million Series D financing with an 8x liquidation preference.

### *How Can Venture Capitalists Negotiate Aggressive Terms?*

Two factors enable VCs to employ aggressive terms for their liquidation preferences and their anti-dilution provisions. The first is supply and demand. Over the past several years, VCs amassed enormous war chests from limited partner investors for their latest rounds of funds. However, the glut of committed capital available in these funds is so great that many VCs are returning the money raised, often by absolving investors of the pledges they made. They can then concentrate on the management of their current funds and portfolio companies. These are the firms that will weather the rough economy. Others are merely dropping out -- ingénues, tourists, and corporate VCs.

The second reason that VCs can negotiate such aggressive terms is information asymmetry. VCs are knowledgeable about the nuances of the provisions they negotiate, and they enjoy a considerable knowledge advantage over the entrepreneurs with whom they negotiate. While VCs negotiate these terms in multiple deals, entrepreneurs generally have little exposure to such terms and concepts. This is particularly true for protective provisions -- their operation in practice is not obvious.

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<sup>2</sup> Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, Nat'l Bureau of Econ. Research, Working Paper No. w7660 (2000), [http://www.nber.org/new\\_archive/jun00.html](http://www.nber.org/new_archive/jun00.html)

Entrepreneurs who lead venture-backed companies may be well educated in technical expertise, but they rarely have the financial background to understand the subtleties of the financing. Often blinded by enthusiasm for their company, they overestimate the likelihood and magnitude of its success and devote little attention to how contract provisions function.

Experienced advisors such as attorneys and accountants can remedy this informational handicap. But even the most conscientious of lawyers are unable to help clients who do not want to heed cautionary signals.

### *The Problems with Draconian Contract Terms*

#### Misalignment of Interests

VCs make investments in portfolio companies expecting that management can increase the value of the company and provide a substantial return on their investments. In this way, management acts as an agent of the VC fund. In every principal-agent relationship there is the possibility of divergent interests. When this occurs, the agent/management engages in behavior that benefits its own position at the expense of the principal/VC's interests. Ruthless liquidation preferences and anti-dilution provisions can exaggerate differences between the two sets of interests and lead to three problematic outcomes.

#### *Outcome Number 1*

##### *Management Engages in Risky Behavior*

When a venture suffers, the liquidation preference represents a significant proportion of the proceeds to be shared and reduces the amount payable to management. This adds a financial hurdle for managers before they realize value from their efforts, and the cumulative effect of preferences in successive rounds only exacerbates this problem.

When an entrepreneur faces lackluster liquidation prospects, there is every incentive to use a bet-the-farm strategy when a conservative course may be more appropriate. The entrepreneur's cost of failure does not increase, and the only opportunity for profit is from the ability to maximize company value, regardless of the improbability of success.

Anti-dilution preferences also exacerbate the principal and agent conflicts of interest but to a lesser degree, since they only are triggered when subsequent rounds of investment are made at lower valuations. In the event of a down round financing, where the firm's current valuation is lower than in the prior round, the anti-dilution provision will preserve the investor's equity stake by imposing the dilution on common shareholders. Management disproportionately absorbs the loss of the value of the company. This disparity

creates an incentive for management to engage in risky activities to avoid down round financings and the accompanying dilution.

### *Outcome Number 2*

#### *Entrepreneurs and Employees Lose Incentive*

Entrepreneurial ventures can produce considerable risk and nominal earnings. These companies are often unable to pay management the large salaries available at more established corporations. Consequently, management derives the bulk of its compensation from the allocation of common stock and stock options, with the expectation that this stock will appreciate in value. However, a liquidation preference may consume the proceeds from a given liquidation event. Once an entrepreneur realizes that he will not realize a good return for his efforts, he may lose the incentive to make a full contribution to the enterprise.

Consider a scenario where a company's potential failure does not significantly increase the financial risk to the entrepreneur. Overwhelming success may be unlikely or unachievable, and moderate success does not lead to a corresponding material reward. The rational behavior for management in this position is to reduce its efforts significantly or abandon the enterprise altogether. Neither choice benefits the corporation or the VC, who must develop an alternative means of inspiring management or engage in the resource-intensive exercise of replacing key company employees.

Similarly, anti-dilution provisions can dampen management's incentive to maximize effort. When the management's equity stake is effectively reduced, the entrepreneurs have less "skin in the game" and a proportionate decrease in the ability to realize gains from their efforts.

Down round financing has psychological effects. The reduction in valuation signals entrepreneur inefficacy. The entrepreneur's resulting embarrassment is exacerbated by the perceived punishment of having equity diluted. This could discourage management and lead to decreased incentive and increased desire to limit effort or leave the company.

Furthermore, liquidation preferences and anti-dilution provisions are clumsy methods to address management performance. They affect all common equity holders alike, even when negative management performance is because of a few employees. Employees who suffer the consequences of liquidation preferences and anti-dilution provisions as the result of the inadequacy of other employees will have a disincentive to maximize their own efforts.

While defenders of these provisions will argue that this "all for one, one for all" mentality fosters team spirit and inspires team success, opponents argue that punishment of all for the failures of few reduces, not increases, incentives.

There are several counterarguments to these expected negative influences on management incentive. First, the threat of triggering liquidation preferences or anti-dilution provisions can provide an incentive to avoid the penalty -- entrepreneurs fearing those negative possibilities will maximize their efforts in advance to avoid them.

This argument fails to account for the effect of negative systemic influences beyond the entrepreneur's control, including economic recessions, changes in the competitive marketplace, and governmental regulations. Incentive structures that fail to link effort and reward accurately risk of providing insufficient incentive to maximize effort.

Economic analysts divide a company's risk exposure into two components. Alpha sensitivity is the risk of an enterprise itself. Beta sensitivity captures how the company's risk correlates with the broader economy. Excessive liquidation preferences and anti-dilution provisions, even if appropriate for addressing alpha risk, are ineffective and unfair tools when employed against a CEO whose ship is going down in a larger economic storm. Even when an entrepreneur should have his stake reduced because of the devaluation, there remains the issue of providing a sufficient incentive subsequent to the dilution to keep his efforts at an optimal level.

A second counterargument is that liquidation preferences and anti-dilution provisions simply adjust for errors in the initial valuation. Increases in information between the last financing and the current financing may reveal a more accurate picture of the company. However, it is not clear why entrepreneurs should bear a disproportionate share of the loss in value when the VCs are probably equally responsible for the mistaken valuation of the company.

Finally, one could argue that these provisions are justified because the departure of employee-entrepreneurs who lose their incentives may be a desirable, not an undesirable, result. If the entrepreneur is responsible for the underperformance of a company, it could be advantageous to restructure incentives to encourage voluntary exit from the venture. Obstinate managers may be difficult or expensive to remove, and they may be potential litigants for costly wrongful termination suits.

### *Outcome Number 3:*

#### *Entrepreneurs May Take Advantage of Private Benefits*

*The third negative outcome of conflicting principal and agent interests from liquidation preferences and anti-dilution provisions is the risk that the entrepreneur will try to maximize private benefits at the expense of the company and VC investors. An entrepreneur who sees that there may no financial rewards from his efforts may be tempted to maximize private benefits. They may take excess advantage of tangible company perquisites --*

*lavish offices, cars, corporate jets, administrative assistance, contracts with friends, and personal services. These benefits are a great expense to the company and have no corresponding cost to the entrepreneur. An entrepreneur may reject or fail to pursue an investor-optimal liquidation opportunity because there is insufficient financial benefit to offset these private benefits.*

## Future Financing Considerations

### *Liquidation Preferences*

Onerous liquidation preferences can have a negative impact on future financing opportunities. Liquidation preferences reserved in prior rounds may be so aggressive as to result in losses, discouraging later investment altogether.

An investor could demand a liquidation preference of its own, possibly with a requirement that the proceeds be distributed on a *pari passu* basis. *Pari passu* is proportionately equal distribution among similarly situated investors when the total return is insufficient to satisfy the total amount due to each party. The *pari passu* treatment of the preference may be desirable for the group without interest seniority; the investor with this seniority is unlikely to relinquish it willingly. And, while this could allocate risk between two groups of investors, it could leave the common shareholders with nothing.

Multiple rounds of liquidation preferences have an even more deleterious effect on the common shareholders' interests. If a company accepts aggregating liquidation preferences, management will reject many potentially profitable liquidations because they produce no financial gain for the common shareholders.

Entrepreneurs knowledgeable about the effects of multiple rounds of preferences will accept them only if they are confident that the company will liquidate at a sufficiently appreciated valuation, leaving the common shareholders with something on the table after the preferences are paid. Rejection of these later rounds of financings may spell the end of the enterprise because the company will not receive the necessary injection of capital. This result has a cataclysmic effect on entrepreneurs and investors alike -- rejection could render the efforts of the entrepreneurs moot and place the return to the early-round investors in the red.

Few venture-backed companies can survive hostile financing terms. Livemind, Inc. is one study in failure. After the VC at Technology Crossover Ventures demanded a 3x liquidation preference, the parties were unable to close the deal and Livemind closed its doors. Since TCV had been Livemind's

principal backer in prior rounds of financing, the firm essentially walked away from its earlier investments of capital.<sup>3</sup>

### *Anti-dilution Provisions*

Anti-dilution provisions may be so harsh that they discourage subsequent round investment completely. Consider a proposed down round financing of Series B shares at \$.50 per share for the issuance of 5 million preferred shares in a company with a prior round of financing of 5 million preferred shares and 5 million common shares. In the absence of an anti-dilution provision, the Series B investor is essentially purchasing one-third of the company's equity for \$2.5 million, at half of the company's prior valuation, with a resulting post-money valuation of \$7.5 million.

The introduction of the anti-dilution provision can have a significant impact on what the Series B shareholder actually receives for the investment. Although the Series B investor may think it is acquiring approximately one-third of the company, the anti-dilution provisions operate to reduce that proportion as follows: full ratchet -- 25% equity (25% less than without an anti-dilution provision); narrow-based weighted average -- 31.25% equity (6.24% less); and broad-based weighted-average -- approximately 27-28% equity (or 4.55-16.65% less than expected, depending upon whether the designated option pool is included in the company's capitalization table). The Series B investor might not think it is receiving everything for which it has bargained.

This result affects not only the investor's proportionate share of the ultimate division of profits, it reduces the efficacy of its control rights through voting, in the intervening time frame. This unfavorable effect is difficult to overcome because the decision to either issue more shares to the prospective Series B investor or reduce the per share purchase price will inevitably trigger the anti-dilution provision. In short, the inability of the Series B investor to readily purchase the desired percentage of equity for a given price may prove to be an insurmountable obstacle in the consummation of the financing round.

Defenders of the anti-dilution provision may argue that the Series B investor in a down round financing is already protected by the reduction in the per share purchase price. In other words, to obtain an equity stake in equal proportion to the Series A investors, all the Series B investor must do is purchase shares at the original, non-discounted price.

This observation ignores the fact that the company has received a lower valuation on the basis of information that was unknown to the parties who participated in the initial round of financing. This is true regardless of whether the lower valuation is the result of the company's individual performance or the economy. The new valuation should reflect the most current information

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<sup>3</sup> Suzanne McGee, Late-Stage Venture Firms Play Hardball, Wall St. J., May 17, 2001, at C1c3.

available and accurately portray the worth of the company, not merely serve as a phantom figure to be manipulated arbitrarily in order to mitigate the effects of the anti-dilution provisions.

As with liquidation preferences, the failure to inject the needed capital, even at a discounted rate, may expose the company to the possibility of collapse. That result would benefit neither the entrepreneur nor the initial investors.

### *Conflicting Interests in Sales or Mergers*

The introduction of a new party to the contractual relationship may present conflicts if the new entrant, for example, an acquirer, can enhance the position an original party over the other original party's interests. There may be a temptation for the newly arriving party to collude with an existing party to maximize gain.

While this may be mitigated by assigning to the more vulnerable party the decision of whether to trade, the defensive mechanism more likely to be employed by the entrepreneur is the failure to engage the potential acquirer, in hope that the acquirer's proposed purchase is not brought to the attention of the VC.<sup>4</sup>

### *Effects on Relationships with Creditors*

Although common and preferred shareholders feel most painfully the effects of severe liquidation preferences and anti-dilution provisions, the damage can extend further -- even to the company's creditors. Many high-tech ventures have substantial equipment demands, and these needs often are financed by conventional banks, leasing institutions, and equipment manufacturers. Typically, these loans are contingent upon the satisfaction of a variety of conditions -- performance is one example. The failure to secure a subsequent round of funding can have a costly effect on the company's daily operations and add new burdens to its capital structure.

### *Limitations on Strategic and Exit Opportunities*

The negative impacts of liquidation preferences and anti-dilution provisions that discourage subsequent rounds of venture funding also can affect potential relationships with strategic partners, acquirers, and merging partners. One way to compensate potential strategic partners is by issuing common stock or stock options. However, the value of this stock to the strategic partner is highly contingent upon how much it benefits from liquidation events and the degree of dilution of its equity stake. As a result, liquidation preferences and anti-dilution provisions either increase the cost of

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<sup>4</sup> Erik Berglof, *A Control Theory of Venture Capital Finance*, 10 J.L. Econ. & Org. 247, 249 (1994).

embarking on such partnerships or discourage the establishment of the partnership entirely.

There is a similar effect on mergers and acquisitions. Merging companies often complete the merger through an exchange of common stock. Because of liquidation preferences and anti-dilution provisions, the decrease in value of this stock may be inadequate to foster a deal or to compensate the company and its preferred and common shareholders for its efforts and assets. These effects have had a poison pill quality for the past two decades, discouraging unwanted acquisitions of publicly-traded corporations. Liquidation preferences and anti-dilution provisions produce the same result -- they can discourage a reasonable acquisition when the potential acquirer is concerned that too much of its purchase price is being used to compensate early-round investors. Also, this may come at the expense of the entrepreneurs whom the acquirer must keep motivated if the acquisition is achieved.

#### *Failure to Close -- Lose the Deal*

The drawbacks of early-round liquidation preferences and anti-dilution provisions may also affect the VC before a deal is struck. A savvy entrepreneur may knowingly or instinctively avoid the VC's aggressive provisions and seek another investor who is able to offer more reasonable conditions to financing. The VC may lose the chance to gain from the successes of a fledgling enterprise. This result would not only hurt the performance of the individual fund but also diminish the firm's competitive standing among comparable VC players who might fund and profit from the young company. Indeed, the most aggressive negotiations may unwittingly lead to adverse selection of companies for their portfolios, as competent entrepreneurs seek other sources of capital. The VCs could be left with entrepreneurs who have no other options.

To this, a VC may reply that there are countless deals lurking immediately behind every good business plan. While this may be true, it is perhaps even truer that VCs seek home run returns on their investments, not only for their financial benefits, but also for the effects on reputations associated with such discoveries. Every VC is looking for the next eBay, Cisco, or Yahoo.

Vcs may also assert that the collusive nature of the VC industry limits the degree of variation among firms, particularly in periods when the supply of funding and the number of firms are shrinking. The reality is that even in deep economic troughs, individual firms will compete with one another, and the terms they offer serve as a differentiating factor.

#### *Ethical and Legal Liability*

Onerous provisions in VC contracts with entrepreneurs can have effects beyond financial costs -- excessive terms may expose venture funds to ethical

or legal liability. The origin of this liability is rooted in the information asymmetries between the parties. One often hears that VCs seek favorable terms and comprehensive control rights, because the entrepreneurs they fund enjoy an information advantage about the intricacies of a portfolio company's performance. It is even more common for VCs to have greater sophistication regarding the subtleties of venture financing than inexperienced entrepreneurs.

To the extent that entrepreneurs are involved in the negotiation of term sheets, they tend to focus on the established valuation of the company and on their percentage of ownership. However, clever contractual devices can render a valuation and capitalization table totally meaningless, particularly when the venture fails to achieve overwhelming success. Non-executive employees who are compensated primarily by stock options are likely to be even more uninformed about how liquidation preferences and anti-dilution provisions can undermine the value of their equity stakes.

A VC may argue it has a duty to its limited partners to strike deals that are most favorable to its investors and that entrepreneurs may protect their interests by having advisors represent them as vigorously as possible. The VC may contend that an entrepreneur who fails to educate himself about the practical application of certain contractual provisions will be subject to the consequences of this lack of due diligence. This attitude not only ignores the potential financial costs associated with overly aggressive provisions, it also undermines the partnership and mentoring that theoretically forms the backbone of the VC-entrepreneur relationship.

An entrepreneur will surely lose confidence in the VC's loyalty once it learns that the VC did not adequately explain the effects some terms might have on the entrepreneur's stake. Consequently, all the VC's sage advice to the company will likely be suspect and possibly unheeded.

The VC also may claim not to be too concerned about its failure to clearly articulate the potentially detrimental effects of certain harsh provisions on the entrepreneur. Entrepreneurs are rarely repeat players in the VC industry, so there is seldom the opportunity for an entrepreneur to "punish" the VC by seeking future funding of other companies elsewhere. This cavalier attitude ignores the fact that a VC's reputation for how it treats entrepreneurs can spread within the entrepreneurial community and discourage other entrepreneurs from negotiating with VCs known to obscure financial realities with subtle provisions.

VCs are perhaps more openly concerned about their reputation with their limited partners. These investors are likely to be indifferent to the terms used in financing the portfolio companies. Nonetheless, while the use of specific terms may not influence an investor's decision to participate in a fund, their returns on their investment do. Consequently, when overly aggressive

provisions harm the performance of a portfolio company, the result is felt in the return to the fund and does affect the return to investors.

The argument that the effects on a VC's reputation should discourage VCs from employing elusively draconian liquidation preferences and anti-dilution provisions may not be persuasive because many financings are funded by multiple VCs. The funding method is called "syndication," when two or more funds contribute capital, board membership, and managerial oversight to the portfolio company. Syndication can spread risk and share oversight responsibilities.

When several VCs participate in a financing round, the reputation costs associated with driving aggressive bargains fades, and it is more difficult to identify specific VCs with reputations for using disfavored provisions. A term sheet may reflect the position of the most self-protecting VC but will not necessarily reveal which VC that is. But the fact that it is more difficult to ascertain which firm seeks which provisions does not make it impossible for firms to develop such reputations.

Unlike the entrepreneurs whose returns may be diminished by liquidation preferences and anti-dilution provisions, a VC receives its management fee every year, regardless of its performance. Additionally, a VC's receipt of the carried interest is not subject to the more senior preferences or dilution terms. Often, VCs draw their returns before a fund is closed and before proceeds are distributed to the limited partners. These examples illustrate that VCs are unwilling to consent to the same kind of financial terms that they expect entrepreneurs to accept.

#### Venture Capitalist Agreements and Their Limited Partners

While VCs may defend liquidation preferences and anti-dilution provisions as ethically justifiable, it is not likely that we would see similar terms in agreements with limited partners. In fact, the agreements struck by VCs and their limited partners are straightforward with few moving parts. In these relationships, VCs are typically compensated by (1) their annual management fee of 2-3% of the fund; (2) their "carry," generally 20% of the profits returned to the partnership; and (3) their ability to participate directly in the investments they make for the fund.

These agreements may restrict VC behavior, but their terms are related more to broad guidelines regarding fund operation than to a system of de facto financial penalties. Venture capital fund limited partnerships often include covenants relating to:

- Restrictions on the size of investment in any one portfolio company
- Limitations on the use of debt

- Restrictions on co-investments with prior or subsequent funds managed by the VC
- Conditions subsequent to the reinvestment of earned profits
- Limitations on personal investments by VCs in portfolio firms
- Transferability of the VC fund's general partner interests
- Limits on fundraising for future funds
- Requirements to devote "substantially all" of the VC's efforts to the management of the fund
- Restrictions on the addition of new general partners
- Limitations on the types of investments to be made
- Coverage for the loss of key fund personnel
- Conflicts of interest
- Disclosure requirements
- Profit distributions

While VCs face the costs associated with a poor return on investment, these costs pale in comparison to what faces entrepreneurs and employees under the same circumstances. These consequences are at least as grave and include loss of employment, loss of sweat equity, loss of initial sacrifices of capital, and lost opportunity.

VCs may rationalize an entitlement to aggressive terms based on the expertise they bring to an enterprise. VCs are quick to accept credit for the upside gains achieved by a company, but they are even quicker to disclaim responsibility for underperformance. The purpose of liquidation preferences and anti-dilution provisions is to protect the VC's investment, even though the company's lackluster performance may be due to inadequate and flawed advice and oversight by the VC. This is patently unfair.

VCs unconvinced by an appeal to their ethical sensibilities may find the long arm of the law more persuasive. Failure to disclose contractual provisions may give rise to a cause of action by the entrepreneur against a VC. VCs may have legal duties springing from their positions as corporate directors or even as controlling shareholders. Among the traditional fiduciary duties are the duty of care, guided by the "business judgment rule," and the duty of loyalty. California has codified its duty of care, requiring directors to fulfill their duties to the corporation "in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders, and with such care,

including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.”<sup>5</sup> In defining the contours of the business judgment rule, most courts use a negligence standard.

The duty of loyalty, on the other hand, requires fiduciaries to promote the interests of the corporation without regard for personal gain. The duties of care and loyalty apply to both directors and controlling shareholders in most jurisdictions. In at least one state, broad fiduciary duties are not imposed on stockholders of a closely-held corporation under law. A VC who is not on the board of directors but represents a controlling share of voting stock may owe fiduciary duties to the minority shareholders.

Even if cases do not go to trial, the costs of preparing for litigation and potential settlement costs could prove to be significant.

#### *Punishing Current Entrepreneurs for Prior Failures in a Hot Market*

Disappointing investments from the Internet bubble seem to drive the use of excessive liquidation preferences and anti-dilution provisions in the current economic climate. Those portfolio companies received financing at valuations that were not justified by fundamental economic analysis. When the public market started to tumble, it brought countless private companies down with it. When portfolio companies suffered liquidations at depressed prices or down round financings, imposing oppressive terms on entrepreneurs seemed to be the answer.

The VCs may be misplacing their punishment. The companies seeking funding now did not commit the sins that contributed to weak returns over the past several years. A portion of responsibility for the weakness in the VC industry falls to the VCs themselves for allowing dizzying indefensible valuations. Inflicting severe terms on worthy companies is not the answer.

#### Better Ways to Ensure Effective Management

No one would question a VC's interest in protecting the fund when financing a new enterprise. However, there are a number of means of protection that are superior to onerous liquidation preferences and anti-dilution provisions.

First, VCs typically negotiate for representation on the portfolio company's board of directors. From these positions, VCs can take on a stewardship role and influence optimal decisions.

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<sup>5</sup> CAL. CORP. CODE § 309(a), <http://www.leginfo.ca.gov/cgi-bin/displaycode?section=corp&group=00001-01000&file=300-318>

Second, a VC's funding can be separated into stages called "tranches." Funding is released upon the completion of predetermined milestones. If the company fails to reach the milestone, the VC may either proceed with the funding or exercise the right not to contribute previously committed capital -- not "throw good money after bad."

Third, VCs may retain veto rights over certain events or activities, allowing them to steer the company in a profitable direction.

Fourth, distribution of founder and management stock can be on a vesting schedule. For example, 25% of the shares could be issued after the first year and the remainder on a monthly basis for four years. Delayed vesting ensures that management is provided with sufficient incentive to remain active in the venture. That assumes, of course, that liquidation preferences and anti-dilution provisions don't consume the value of these vesting shares.

VCs may use liquidation preferences and anti-dilution provisions to punish an underperforming Chief Executive Officer. It probably is preferable to replace these CEOs rather than have them remain with inferior incentives and resentful attitudes.

VCs should try to mitigate some of the harsher effects of protective provisions. While both liquidation preferences and anti-dilution provisions are justified as incentives for maximizing management performance, they clumsily punish the well-intentioned CEO whose enterprise falls victim to broader systemic risks. In an conversation with Professor Joseph Grundfest of Stanford University, he suggested a novel approach to protecting the entrepreneur against this risk -- tying the valuation of the company to a market index, like the S&P 500 or NASDAQ 100. When a company's decline in performance corresponds to a drop in a broad market index, the liquidation preferences and anti-dilution provisions would not be triggered. Founders and management would not be disproportionately punished for systemic economic shocks.

The optimal way for VCs to protect their interests and provide the highest return for their limited partners is to select the most promising companies for their portfolios. Rather than devote time and attention toward finding the right partner, VCs try to protect against the risk of divorce. It is challenging and risky to identify the portfolio companies that will be successful, but these constraints produce potentially great returns and healthy compensations for VCs.

A related issue is a necessary rededication to ascertaining the true worth of companies, based on actual and projected revenues, not "eyeballs" visiting websites. Consider the approach taken by Ignition Corp., a VC that recently raised \$285 million for a new fund. This VC decided to invest only in areas where they have expertise, recognizing there are other fields with enormous promise like biotechnology or health sciences. "But, we don't know those areas," said managing partner Brad Silverberg. "In fact, we don't even know

what we don't know." This stick-to-your-knitting humility appeals to investors. The investors in the new fund include Harvard University, Princeton University, Stanford University, the Sloan Foundation and GM Pensions.<sup>6</sup>

### *Mitigating the Harshness*

Contract provisions can mitigate the harshness of otherwise draconian terms. A liquidation preference can be drafted with a not-to-exceed cap -- a preferred shareholder may have a 3x liquidation preference that cannot exceed 5x. Then, when the conversion to common stock would provide a return in excess of the 5x cap, the preferred shareholders would forego the liquidation preference, convert their shares to common stock, and share the proceeds on a pro rata basis instead.

While the application of this cap appears equitable, it may not do enough to soften the negative impact of liquidation preferences, particularly at more modest liquidation valuation amounts. A cap is theoretical until fairly successful liquidation amounts are achieved. The effect of the liquidation preferences could be retrenched further with smaller multiples and smaller caps (for example, a 2x preference with a 3x cap). This is a far more reasonable preference.

Similarly, there are ways to mitigate the negative effects of anti-dilution provisions. The parties could include a pay-to-play provision -- require preferred shareholders to contribute additional capital to purchase the shares that they have been allocated as a result of the dilution. The company receives additional capital in exchange for the lower conversion price, and the earlier-round investors must express their continued financial commitment to the company.

Anti-dilution provisions also can be drafted to exclude potential key employees and strategic partners. To accommodate these carve-outs anticipatorily, the parties would have to know which potential shareholders might be covered under the exclusion. If the standard is too flexible, the company remains captive to the VC's determination.

Management carve-outs can also reduce the negative impact of liquidation preferences and anti-dilution provisions on company employees. For example, a term could state that at an exit above a predetermined amount, 10% of the proceeds will be distributed to the management team at the discretion of the board of directors.

A variant of the management carve-out is a restart. A restart round occurs when a startup's valuation is significantly reduced and its current investors' stake is diluted. Current investors that don't re-invest are out. The

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<sup>6</sup> Steve Lohr, *Fund Raises \$285 Million for Start-Ups*, N.Y. Times, Dec. 20, 2001, at C4.

use of the restart can have a negative impact on the interests of management, particularly management involved in its early stages.

Defenders of aggressive liquidation preferences and anti-dilution preferences are likely to point out that preferred shareholders enjoy the right - but have no obligation -- to exercise these preferences. If a VC felt that the terms negotiated were having a deleterious effect on the management of the company, they could waive some or all of their rights. This argument overlooks the fact that these potentially harmful liquidation preferences and anti-dilution provisions are default provisions.

In conducting the affairs of the company, management will proceed under the assumption that the terms are fixed obstacles. Even if the entrepreneurs are able to convince the investors to forgo or limit their negotiated rights, the entrepreneur's risk that the preferred shareholders will reconsider and vote to maintain the status quo. Even if a VC consents to loosening the protective provisions, the negotiation of these retrenchments adds cost, friction, and risk to the consummation of the deal in question.

Supporters of strong liquidation preferences and anti-dilution provisions assert that they are so tied to underperformance that they are justified control mechanisms. This ignores the reality that both types of provisions produce such a drag on companies, they effectively hamstring a wide range of potentially rewarding deals. When systemic failures such as broad economic downturns compromise a company's financial outlook, it is patently unfair that only the common shareholders bear the downside risk that results from onerous liquidation preferences and anti-dilution provisions.

Excessive liquidation preferences and anti-dilution provisions are deceptively attractive methods for VCs to preserve investments and maximize returns. However, when the terms are too draconian, they have a negative impact on the worth of the very portfolio companies from which high returns are sought. Management incentives are misaligned, future financing opportunities are compromised, and the VCs may incur legal liability as a result of the terms used to try to protect their investment. VCs should concentrate on increasing their portfolio's value, not through financial chicanery, but by bringing profitable products to the marketplace.

Discontinuities require massive change and the venture capital community is faced with needing to change its practices and to lead themselves and their portfolio firms in new directions. The opportunities to retain investor assets and build value will be recognized by the players that address these market and risk dilemmas.

## Sarbanes-Oxley: Its Impact on the Venture Capital Community

JOHN DEXHEIMER \*

Carla haugen \*\*

In the aftermath of The Perfect Storm that blew across the public markets, the venture capital industry was ready to get back to business as usual. A concession that most of the 1990s were the best decade the venture industry will ever see has moved most venture capitalists to wish they could go back to the way venture capital worked in the 80s. But alas, and to layer a metaphor, we're not in Kansas anymore.

The Sarbanes-Oxley Act of 2002<sup>17</sup> is not just changing the landscape for corporations. It has created a new continental divide.

When signing the Act in July of 2002, President Bush said, "The Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders."<sup>18</sup> Organized into eleven sections, the Act deals with such issues as auditor independence, director independence, corporate responsibility, financial disclosure, conflicts of interest for directors and attorneys, insider trading, corporate accountability, and internal control and reporting. It establishes a public company accounting oversight board.

Experts characterize Sarbanes-Oxley as creating the most sweeping changes since the Securities Acts of 1933 and 1934. It is too easy to look at these actions as reactionary, enacted just because of a few large corporate bad apples.

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<sup>17</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

<sup>18</sup> <http://www.whitehouse.gov/news/releases/2002/07/20020730-10.html>

The consulting firm of McKinsey and Company notes that the investment community is on the bandwagon for reform: "Governance has moved to the heart of the investment decision with more than 60% of institutional investors. More than 60% stated that poor governance might lead them to avoid the stock of a company." <sup>19</sup> Red Herring magazine, a bastion of venture capital support, took the position in its October 2002 issue that "the Act needs to be recalled to avert a clash between sound corporate governance and innovation." <sup>20</sup> While the rules may change in some regards and grandfathering of implementation on some items may take place, a major recall or modification appears unlikely.

Unfortunately, the Red Herring editorial also defends practices in the venture capital community not aligned with proper corporate governance. These quips characterize the rhetoric of much of the venture capital community and its management teams:

"The pendulum will swing back as the economy improves and politicians move on to their next battle."

"It doesn't really affect small public companies very much as the focus is on large firms."

"We can wait on a lot of items to see how things evolve in DC and NY."

"It certainly doesn't affect our private deals."

Each of these statements is false. More than just saber rattling from Washington, Sarbanes-Oxley has broad, derivative implications that few attorneys, accountants, or boards have fully appreciated or begun to address.

Real-time disclosure of material product and customer events and faster quarter close requirements will put time and cost pressure on financial staffs, senior management, and boards.

Option accounting changes and shareholder activism will create discontinuities for some individual firms and the fund industry. Compensation experts and large institutional shareholder groups are advocating eliminating fixed price option programs in favor of indexed options and restricted stock, with long holding periods. Proxy voting over the next several years will reject many compensation and option plans.

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<sup>19</sup> Quoted at <http://www.auditsupervision.com/>

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<http://www.redherring.com/Article.aspx?f=articles%2farchive%2fmag%2fissue118%2f4525.xml>

Speculation is that sector funds, a staple of small cap investing, could dwindle because of the increased overhead for funds needing to certify their results.

Mutual Funds will have to disclose proxy voting results and reasons or risk having assets withdrawn or threatened to be withdrawn by large fiduciary players like CALPERS, AFL-CIO, and TIAA-CREF.

The investment banking business will change dramatically. Initial public offering (IPO) allocations will continue under scrutiny and research conflict and compliance will be much tighter. The ultimate resolution of the IPO Securities Litigation Case<sup>21</sup> against underwriters and corporations is likely to change the IPO process, legal terms, and liability and indemnification procedures substantially. The investment banking leadership community is taking actions to be consistent with a resized IPO market that focuses on larger and fewer IPOs.

The costs of being a public firm are going up dramatically. Scale not only matters, it is required. Unless exemptions are instituted in new rules, small public firms and new IPOs will be ill positioned in this environment. Although this is not what venture capitalists and entrepreneurs want to consider, the true small cap market may not bounce back as in past cycles. And most venture capitalists aren't prepared to deal with the derivative implications that will affect them and the management of their own businesses.

The ideal of information transparency in the public market is flowing into the hedge fund market with expected regulation and disclosure. It is also beginning in the venture capital fund industry via the Freedom of Information Act, actions at Public funds, and the tension between management and venture capitalists during a downturn. This will continue as a direct result of several Sarbanes-Oxley disclosure requirements.

Add to this mix limited partners accusing general partners of bad investment decisions, mismanagement, fraud, and breaches of fiduciary duty. Even more -- portfolio companies are accusing general partners of failing to live up to their duties of loyalty and care as board members.

#### Greater Cost and Reduced Flexibility for Public Companies

Answers to questions asked privately and at panels on Sarbanes-Oxley suggest that for comparative work, audit fees will increase 15-30% per year, legal service fees 10-20% per year, and costs related to directors and officers (D&O) issues will vault 50-100% each year for the next several years.

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<sup>21</sup> 21 MC 92 (SAS).

While accountants may seem embattled, their survival and effective oligopoly will allow steady increases in audit fees in coming years. Insurance carriers can look to the next several years for makeup time for recent disasters. They've hit the jackpot on D&O coverage.

Companies can expect to add new expenses required by Sarbanes-Oxley to support specific internal control and audit committee activities. For a typical \$50-100 million revenue technology firm, which may now pay \$2-3 million for these services, with D&O insurance as the biggest piece, the result will be at least a doubling of those expenses in two to three years. That's 5-10% of revenue and likely 50% of targeted pretax income! These factors point toward two actions.

The obvious one is to manage the cost increases with a particular focus on D&O. Easier said than done, this argues for monitoring and compliance with evolving "Best Practices" of the governance, audit and compensation guidelines D&O carriers will be monitoring. NACD, ISS, AICPA, IIA, IRRC, AFL-CIO Paywatch, and the Council of Institutional Investors all have large and active roles in driving Best Practice guidelines that affect auditing, compensation, options, board governance and proxy voting that influence large mutual fund and ERISA investors as well as directors and officers. Ignoring these will cost more money, risk losing large portions of the investor base, and impact proxy votes. Not a wise choice to make knowingly.

The second action is to get scale rapidly and absorb the growth or acquisitions overhead with growth or acquisitions or be acquired and exit the public market. Obviously, these are major strategic and governance considerations. Acquiring to get scale is a viable and necessary path for many venture capital-originated companies operating in lower baseline growth environments or crowded competitive spaces where consolidation economies can be realized.

Yet the Sarbanes-Oxley environment makes these moves more risky and difficult since (1) the company now must certify the financial results of the company being acquired if it is material; and (2) the internal controls of the acquired company need to be certifiable as well. The result is that acquisitions will be more carefully pursued, with deeper due diligence and a SWAT team approach to integration, both operationally and in financial controls.

#### The Impact on Venture Capital Liquidity

Most venture capitalists say they will need the next few years to go back to basics and build sizable companies in the private market, sell them without large-scale opportunities, and take public those that reach scale. Great, but beware that Sarbanes-Oxley may apply sooner than you think to the private firms and actions they might take. Remember the 8,000 - 10,000 firms venture capitalists backed since the mid 90s?

To the buyer, selling a portfolio company for a material amount means you need to comply with Sarbanes-Oxley. This includes a 5-year look-back to determine fraud, manipulation, or a lack of internal controls. It will result in lower prices and larger and longer escrows. A buyers' market will cut returns and options for exits over the next few years.

#### Venture Capital Practices Must Change

Feeding the winners to get to scale has planning implications that will create issues in conflict with legal requirements and "Best Practices." In any event, a company must be in full compliance when it files the initial S-1 with the SEC.

This means the company needs to staff its board committees with independent persons and establish its internal controls at least a year before filing. One National Association of Corporate Directors Best Practice is that no outside director with a full-time job should serve on more than 4 boards. Also, a full-time professional director should serve on no more than 6 boards and 3 audit committees. While one may argue the applicability of this guideline to both public and private boards, the firm's director and officer liability carrier is likely to monitor this and apply exclusions from coverage if the guideline is not met. There is a need to disclose exactly how many boards one serves on to provide the necessary transparency.

American venture capitalists have long practiced the Japanese concept of *keiretsu*, where groups of companies gain competitive advantage by creating long-term full-group strategies. The companies often own equity in each other. The Sarbanes-Oxley requirements for independence are likely to cause more scrutiny of potential conflicts in this historic venture capital practice.

Once disclosed, information previously undisclosed may raise uncomfortable issues. Directors from two different venture capital firms previously seen as independent may no longer be considered independent. Once disclosed, common investments, the identity of common limited partnership investors, and board actions could be interpreted as actions in concert. Aggregate ownership could eliminate some venture capitalists as candidates for board and committee work. If the venture capital community extends *keiretsu* to directors, lawyers, and investment bankers to invest in their funds and deals, there will be substantial interlocks among venture capitalists across companies. Any company doing business with another venture capital firm's board member's portfolio company will undergo a greater level of scrutiny and disclosure than ever before. The result will be significant changes in practices. Since many major venture capital limited partners are among the main drivers and watchdogs of the changing environment, their attention to these details of transparency will increase as it influences their own results and public initiatives.

### The "NEW" Audit Committee

Audit committees are drawing particular focus. As explained by the New York Stock Exchange's Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees:

In its oversight capacity, the audit committee is neither intended nor equipped to guarantee with certainty to the full Board and shareholders the accuracy and quality of a company's financial statements and accounting practices. Proper financial reporting, accounting, and audit functions are collaborative efforts conducted by full-time professionals dedicated to these purposes. The audit committee, as the first among equals, oversees the work of the other actors in the financial reporting process - management, including the internal auditor, and the outside auditors - to endorse the processes and safeguards employed by each. In particular, the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management's accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor's practices.<sup>22</sup>

Time commitments will undoubtedly increase. Estimates in numerous industry forums and polls of existing members of audit committees of public firms suggest the time required increases by 3-5 times over two years ago. "Independence" and "financial expertise" are merely the beginning of the list of the items required of audit committee members under Sarbanes-Oxley in Sections 301, 406, 204, 906, and 302. They must:

- Select, retain, and evaluate independent auditors
- Engage outside advisors
- Establish a process for confidentially receiving and independently reviewing financial whistleblower complaints from employees and other sources. These sources include the firm's lawyers, who lose the attorney client privilege under Sarbanes-Oxley.
- Implement a code of ethics
- Prohibit directors who are not considered independent from serving on the audit committee
- Determine that no member of the audit committee has any business or family relationship with the company or its management team.

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<sup>22</sup> <http://www.nyse.com/pdfs/blueribb.pdf>

- Review the performance of audit committees
- Evaluate appropriate compensation levels, indemnification, and director and officer insurance to attract and retain qualified members
- Review all alternate accounting treatments
- Review and all financial statements and financial disclosures at least once in each quarter
- Review and accounting policy issues at least once in each quarter
- Review internal controls to identify key risks and monitor corrective actions
- Monitor the company's internal audit function
- Prohibit all officer loans
- Prepare full review of financials for the SEC at least every 3 years
- Implement training and education programs to ensure that audit committee members remain current on recent accounting and finance developments

Sarbanes-Oxley and the associated NYSE and NASDAQ requirements are at relatively early stages of implementation and the essential elements of compliance and new practices are clear. They constitute major changes for boards and senior management over the next several years and the greatest change in corporate finance and governance in over 50 years. While Congress targeted Sarbanes-Oxley at the largest firms in the US, an entire new body of law and practices will evolve over the coming years that will trickle down to the smaller public sector, including aggressive private firms, many backed by venture capital, that have relied on the public markets for growth.

#### Actions to Take

##### Get going on implementation

This marked transformation will affect everyone. There is a need for new processes among boards, committees, and management. Substantial set-up times and costs will require new internal resources and costly outsourced resources. The good news? Setting benchmarks and measuring a company against prevailing and forthcoming best practices will gain respect in the investor community, make dealing with the SEC more manageable, and set a framework for minimizing risk and long-term cost.

### Reset expectations

Costs will increase for all companies. Small cap firms, particularly those under \$300 million in revenue, could see decreases in baseline earnings. Coupled with the flow of capital expectations, profit-earnings ratios may not return to the peaks of the late 90s.

Require scale. It is likely that the minimum level of revenue for a firm with a quality IPO will be \$50 million. Acquisitions will help smaller firms get the scale and breadth of customers to enable lower disclosure financial risk, a critical concept in the new regulations. A S.W.A.T team approach involving management and outside assistance will provide proper execution and compliance with audit committee guidelines.

Success for venture capitalists in the next decade will not be predicated simply on a return to past practices. It will incorporate new realities of the public market. Good venture capitalists and good investments are market driven and customer focused. Large investors, including parent entities of leading limited partners of venture capital funds, with the help of SEC oversight, have changed quickly. They have become a more informed, active and demanding group. According to L. Modigliani of Morgan Stanley, "In today's post-Enron environment, we believe that investors will pay a premium for companies with high governance standards".<sup>23</sup>

Discontinuities require massive change and the venture capital community needs to change their practices and to lead themselves and their portfolio firms in new directions. The opportunities to retain investor assets and build value will be recognized by the players that address these market and risk dilemmas.

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<sup>23</sup> [http://www.jmdutton.com/PDF\\_Files/2002\\_ISS\\_CGO.pdf](http://www.jmdutton.com/PDF_Files/2002_ISS_CGO.pdf)

## Kommerstad Center Speakers Forum

### Achieving Goals

RANDY KOMINSKY \*

*Introduction of Mr. Kominsky by Professor Edward S. Adams, Co-director of the Kommerstad Center for Business Law and Entrepreneurship:*

*Professor Ed Adams:*

It is my pleasure today to introduce Randy Kominsky. Randy is the chief investment officer for the holding company of Carl Pohlad, the owner of the Minnesota Twins.

Randy is a lawyer by training. He graduated from Temple University Law School in 1979. He has been a partner at Coopers and Lybrand and head of its restructuring group. He was on his own for a period of time. He has worked in senior management for Ryder Systems. He served as the co-chair of the Unsecured Creditors' Committee for the Continental Airlines bankruptcy, where he was extensively involved in every aspect of the case, supervising the revised business plan, restructuring a \$4 billion capital structure, implementing significant cost reductions, and negotiating and valuing new equity from financial and strategic partners.

I cannot express to you enough how highly regarded he is in the financial community. He will give you a real perspective on what it is to be a lawyer and then pursue what I would characterize as a non-traditional career. We are just thrilled to welcome him today.

*Mr. Kominsky:*

As Professor Adams said, I am the Chief Investment Officer for Carl Pohlad, listed in Forbes as one of the world's richest men. Now that you know that, I'd like to ask some questions of everyone.

How many of you would be interested in working with me after you graduate? Raise your hands. OK, pretty much everyone. Keep your hands up, please, while I ask you a few questions.

What if I told you that the job required you to work every Saturday and probably two Sundays a month? If you're not interested, drop your hand. We still have some hands up.

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\* Mr. Kominsky is the Chief Investment Officer for CRP Holdings LLC. His primary area of responsibility is making equity investments in privately held companies.

What if I told you that the job pays \$15,000 a year? All right, a couple hands still up.

Let's discuss some of your qualifications. For those with your hands still up, how many have taken accounting classes? A couple hands still up.

How many, of the few hands up, have published something?

Now, how many of you can deliver an unbelievable recommendation to me from somebody that I might know?

OK, and how many of you have leadership positions right now?

No hands standing? Nobody hired!

What I hope to accomplish in the next hour is to give you my thoughts on how you can accomplish your goals. You all said you wanted to work for me, suggesting it was a goal -- yet not one of you has the qualifications to work for me. I'd like to go over some things I think would be important for you to do to be able to accomplish a goal.

I've been out of law school for 22, 23 years, and I can tell you that you will not remember 99% of the stuff you're learning now. That is just a fact. Think about your whole undergraduate experience. How many of you truly remember most of what you learned in those 4 years as an undergrad? I'm going to help you remember. And as I talk, I'm going to list a few words or phrases that, if you're so inclined to think about and look at, I will have considered this a successful use of my time.

I'm going to try and list the skills that I think are relevant for you to accomplish your goals. Then I'll try to illustrate those skills with my life experiences.

You are all very capable, hard working, bright people. You are always prepared and you always do your best. Those skills are just the ante to get into the game. The traits that made you a part of law school made everybody else a part of law school.

What makes you different from someone else? What separates you from anybody else? As a professional. As an individual. Why should I hire you as opposed to the guy next to you? Distinguish yourself. There are a million lawyers -- what distinguishes you?

### *Learn Business*

The first goal to accomplish while you're young and have these resources available to you? Take business courses.

If you want to be a business lawyer, you have to understand business. As an undergrad I got a finance degree and I had a professor who said, "Look, if you were going to live in a foreign country, sooner or later you are going to learn the language." You might learn it there; you might learn it in advance.

The foreign entity on which you are about to embark is business. Business has its own language.

It's not too late to take an accounting class. Go to the business school and audit a couple of classes. What does a balance sheet look like? What's an income statement? Or cash flow? Most lawyers haven't a clue and their eyes glaze over when they're given financial statements. Learn to read a financial statement and a balance sheet the same way you can read a case or a novel.

And don't worry about the grades. Most people will tell you that grades are critically important. They are, but only for the first job. After that first job, nobody will ask you your grade point average again. Nobody cares. In fact, nobody cares where you went to law school. You're in a top twenty law school. I didn't go to a top twenty law school; I went to Temple. I was never asked where I went to law school after my first job. So it is really not relevant.

### *People Skills and Likeability*

Secondly, people like to work and play with whom and what they like. And charisma counts. A recent article in the Wall Street Journal talked about CEOs and whether charisma plays a large role in becoming a CEO or staying a CEO, and the conclusion was absolutely it does. Not being fake but generally likeable.

How do you become likeable? You are going to have to figure that out based on your own personality. Ask friends and family how you're doing. In the corporate world you get graded and you get reviewed partly based on your personality and you'll either get promoted or you won't.

Let me give you a couple of examples of how people skills and likeability affected my work. I mentioned that I went to Temple Law School. I got to know the dean of the law school very well, just by socializing and walking around the halls. He invited me to Greece on a scholarship the summer between my second and third year. He thought it would be fun for both of us. He liked hanging out with students. So I went and had a wonderful time. It was a major event in my life.

I highly recommend to the second year students to go abroad this summer. Your classmates and other people are going to say, "Oh, my god, you have to get a full summer clerkship to get a job." Well it doesn't work that way, especially in this economy. So don't assume you're going to get a summer clerkship and don't assume that it will lead to a job.

The main reason I suggest travel is that it's really a personality expanding event and you will benefit no matter where you go. It distinguishes you from the guy who didn't do it. Life is way too short and this experience is so much more valuable than others.

Another thing about likeability. I joined a law department of a large corporation after the judicial clerkship - a job I found in the newspaper. (The moral -- look everywhere for jobs!) The assistant general counsel had to decide between me and another person, equally qualified. But, he didn't like the other person and he told the general counsel: "I don't know this guy but I don't like the other guy at all. Don't hire him." I got the job. And that is the way it often is.

Two more vignettes because I think this is critically important. I have a friend and neighbor who is a third year law student. Six or seven people got third year clerkships with a firm, and with this economy, they were thinking about cutting back. Every one of them was very qualified and hard working. But this woman is a person who always has a smile on her face, is always talking to people, and it's fun to talk to her. She got the job and the other people are still looking.

I worked for a company with a guy on staff who was more intelligent than everyone else in the department, but he had no people skills. We brought him into meetings when we needed drafting. He was always the person drafting the documents. And he never moved up in the corporation; he was so focused on being a technician that he had no people skills. The likeability factor is critically important.

### *Mentors*

Get a mentor -- mentors can change your life. A mentor is someone who takes you under his or her wing. In my case, it was a law school professor who taught criminal procedure. I was like you, interested in business, but I had to take criminal procedure because it was on the bar exam. We really got to like each other pretty well. And he knew that I wasn't going into criminal law as a profession. One day he came to me and said, "How'd you like to work for a judge? I got you an interview with one." I hadn't really thought about clerkships, but it was my third year and I said "OK."

The judge and I got on the phone and after a three-minute conversation, he said I was hired. He said it was a done deal before I got on the phone because the professor had said, "You should hire this kid. This kid is great." So, a good way to get your first job is through a mentor. It could be a professor. It could be a lawyer in private practice.

### *Contacts*

The need for contacts, by the way, doesn't go away after you got your first job. It's a way of life. You've all heard the expression "It's not what you know but who you know." It's the truth. People invest in other people just because someone tells them to. People get hired in jobs because of people they know. It happens in your career and it happens in life. And if you haven't done it yet, figure out how and then do it.

### *Change*

Embrace change. Once you get out into the business world, you will hear that change is good. Well, in fact, most organizations hate change and most people hate change, and most people don't want change.

I love change and I have spent my whole life changing. I can tell you that when my mentor-professor approached me about the Florida judge, I wasn't sure what I wanted to do but I thought that moving to Florida was not in my plans. I remember sitting with the recruiters at the law school, they asked me if I was willing to relocate. And I said, "Sure, I live in North Philadelphia and I'd move to South Philadelphia."

So I moved to Florida. My life totally changed and I've been there ever since. I met my wife -- we have a family. And I thought I would live and die in Philadelphia. An important step in the stairway in my career has been to embrace change.

### *Money*

We all worry about money. Don't. One or two of you would accept my offer at \$15,000 a year. My first job was working with that judge was \$10,000. I turned down offers for \$20,000 and \$30,000 from top firms in Philadelphia to go make \$10,000 a year.

Money will come if you enjoy what you are doing. Don't be upset if you're not making \$60 or \$70 grand a year. I never, never, never, ever have made money a primary factor in selecting an opportunity. I've always gone with the experience and the chance to try something new. Go with where you think you are going to have the most fun and the money will come.

### *Get Better*

So if you don't worry about money, what should you worry about? Worry about how to continually learn and change. In my first job, no surprise, I was at the bottom of the ladder. When I heard one of the guys who was senior to me but didn't know me say to another senior guy, "I'm really swamped -- I need some help," I jumped in and said, "I'll do it." He said, "Look, this is nights and weekends and we are really over a barrel here." I said, "I don't care. I want to learn." Because of volunteering for that duty, I became the senior person in the Mergers and Acquisitions area. Then I evolved away from law and negotiated deals. And it all started because I jumped in.

Whenever people said they didn't know what to do about something, I would ask for the chance to try. We started an aviation division -- we were going to own and lease planes and buy aviation parts. I knew absolutely nothing about it. But I learned and it was really exciting.

In the mid eighties, I got really involved with bankruptcies, when a lot of companies were going bankrupt. I was appointed to chair the creditors committee in the bankruptcy of Continental Airlines. It was a wonderful learning experience for me and a highly visible appointment, where I was negotiating with banks and equity holders and boards of directors. In fact, that is where I met Mr. Pohlad. He was the chair of the board of Continental Airlines at the time. We worked together and successfully filed a Chapter 11 bankruptcy and Pohlad trusted me. And all of this happened because I said I want in and I want to do something different.

### *Fun*

Doing the Continental Bankruptcy was also quite a bit of fun. When you start saying I don't like this anymore, I don't want to do this, you will be no good to yourself and no good to your company.

### *Trust*

You will be viewed by most people as someone who can't be trusted -- that is a fact of being a lawyer. One of my mentors was someone whose success was largely based on his ability to earn people's trust. How do you earn trust? Keep your word. Be honest. Keep confidences. Unfortunately, 85% of lawyers don't do these things. That is just the way it is.

### *Preparation*

Let me give you some another thought. Think before you talk. Before you go into a meeting, don't think you can just wing it. Every time you go into a meeting, you will be judged and evaluated. It's not just thinking hard before you go in. It's being creative. Think outside of the box. Don't come up with the answer. Consider alternatives.

### *Responsiveness*

Little things matter. Create a policy of returning every phone call you get on the day you get it. Clients and associates love this. When you get your first job you are probably going to get an assistant who can answer your phone. And you are going to feel real cool.

Don't do it. Pick up your own phone. Clients, co-workers, bosses, associates - they like to talk to you. They don't want to be screened, they don't want to think you are that important, and in fact you are not that important. People who pick up their own phones in the real world are really responsive.

### *Compassion*

The other thing that I would tell you is be compassionate. This is not likeability and it's not easily taught. Do pro bono work -- it's great for you and it's great for the person receiving it. It can be legal and it can be charitable.

And there are a lot of side reasons to do it. When hurricane Andrew struck in Florida it was devastating. I wound up going to a lot of the stricken areas and one of these days was with the Chairman of the Board. We distributed all kinds of stuff and we bonded. He saw me in a whole different light after that day. You can't predict them but those kinds of opportunities will come.

### *Direction and Risk*

Set goals in terms of direction. A lot of these management books will say set a goal, write it down, and achieve it. It's never worked that way with me. I would set a goal in my personal life. I'd get married and have a kid, but it didn't work out that way. We got married and had twins. The goal was

there but the direction was changed. We wanted to have one kid and we got two. So I would say set goals but be flexible.

When I finished the Continental Airlines bankruptcy, it was on the front page of the New York Times. I was being courted by a lot of people when Coopers and Lybrand came to me and said, "We want you to be the partner in charge of our restructuring group but it won't be the practice of law." (I am not a CPA, but I've got enough accounting to be dangerous.)

My first thought was, "Why did I go to law school?" And within what seemed like a split second I thought, "This is great. I can try something different." I embraced the change -- I was willing to take a risk. And I would tell you the same. Be willing to take a risk.

One quick story about the one of the senior presidents at Ryder Transportation where I worked. He was making probably about \$400,000 a year, so he was a pretty well paid guy. He did an acquisition and we paid a guy he knew \$20 million. Same age -- they grew up in their careers on the same path -- had kids at the same time. I asked him what was the difference between them and he said he had young kids, he was being promoted. He was comfortable, but his friend was willing to take risk.

I don't think I've wrecked my life, but I don't have 20 million dollars in the bank. So don't be afraid to change. Now when I became this partner in charge I quickly learned a lot of lawyers do not practice law. The legal training can let you go anywhere. We had a lawyer who was advising on our human resources -- she ultimately became the head human resources person for Office Depot. One of our lawyers was advising a specific a division of the company and he became the president of that division.

### *Politics*

When I was at Coopers-Lybrand, I was doing investment banking which, although it sounds glamorous, means I was helping raise money for companies, and helping turn them around, and doing a lot of banking reconstruction work. I had a lot of people who reported to me and I hired a lot of people and fired a lot of people. One of the things I discovered in this big organization that I didn't like was the politics involved. I had come in as a senior partner, leap-frogging over everyone else. It was unheard of and some people were not very accommodating.

The guy who hired me was the vice chair of the firm. He'd lost an election to become Chair and as far as the guy who replaced him was concerned, I was part of the old regime. It was unpleasant and I said, "This is it -- I'm out of here."

The lesson to be learned is that there is politics in any organization. Politics is just a euphemism for favoritism. And even three-person private practice law firms have favoritism. You'll find it wherever you go. You are not going to change it, don't even think about changing it, and don't worry about changing it. It ain't going to happen.

The only thing you can change is yourself. Either you get accustomed to it or you change your environment. In my case, I chose to change my environment. When I left Coopers, I saw no downside risk -- I could always practice law, another great advantage of having a law degree. Keep your bar admission no matter what you do.

### *Wrap-up*

What I decided to do was form my own company. I went on my own and did a lot of exciting things. I was raising capital for companies and getting involved with projects that I never would have been involved with.

I used the likeability standard. At Coopers, especially as a senior partner, I had to work with everybody and I didn't like it. In my own business, I wanted to work with clients that I wanted to work with. I wanted to work with people I wanted to hang out with. I wanted to succeed on my own.

My advice here is don't rely on partners or other people to bring you clients or business. Become self-sufficient. Meet a lot of people. Go to receptions and cocktail parties and stay in touch with these people. You never know where it is going to lead. Adopt an I'm-hungry mentality and you are going to be successful in life.

So I got a client and we weren't able to raise any money, and I said, "You know, the problem is you have an incompetent CFO." He said, "OK, fix it." And I became the CFO and it totally renewed the business plan.

We fired people. We closed offices. I gave his son a bigger role. I gave the father a lesser role. He was kind of a nice guy but not the best businessman in the world. It's usually the opposite in business -- it's usually the sons who are dopes. Anyway, it was successful and we restructured his business; and I got a lot of money after I restructured. And then clients came by word of mouth, through trust, and I started to sell businesses.

An example. We were doing a management buyout for a guy whose attorney was with the largest law firm in Indianapolis. We secured a \$30 million dollar loan for him but with some really unreasonable loan documents. And the client's lawyer said "You know; it's the golden rule. Those with the gold make the rules." And he didn't negotiate one bit with the bank. I said, "Wait, I am not practicing law anymore and you pay this guy a lot of money. But we can't let the client just sign this contract." I called the bank lawyer and asked if he

was willing to negotiate? He said, "No." I asked again. "Are you willing to negotiate?" He said, "Yes." We went through it, made reasonable changes, and the client fell in love with me. He saw that I used my legal skills to help him. I used those skills to focus on the client.

I could have easily said, "It's not my job -- you hired a lawyer and that's the lawyer's advice." Now he's a friend and a client for life and what did I do? I added a couple reasonable terms here and there.

Wherever I could make some money and have some fun, I got involved. And I always stayed in touch with Mr. Pohlada. When I had clients that needed money, Carl was usually the first person I called. Conversely, if he wanted to look at deals he may have asked me to get involved and do due diligence or fix a problem.

Besides owning the Minnesota Twins, Carl owns a lot banks and a lot of other things. Last year he asked me stop consulting and come to work for his organization as Chief Investment Officer. I said, "Sure, I'll do it!" We didn't really talk about money -- it just sounded like a neat job. And I've been doing it about 9 months.

I told him I wanted to continue living in Florida because I love it and he said that was no problem. I told him I'm not even sure how long I'm going to work for him, because I like change. He said no problem. He is one the nicest people I have ever known. So I started and what do I do?

Think about when I started talking to you today and asked you those questions. Not one of you asked, "Wait, what do you do for a living?" "What am I going to do for a living?" Nobody asked me what his or her job is going to be. You probably assumed it would be something glamorous and sexy. It could have been janitor. The lesson to be learned? Ask questions and, most important, listen.

Lawyers have a tendency to like to hear themselves talk. My advice? Don't talk. Ask questions and listen. First, by listening to the other person, you can become closer to that person. Second, you will really understand the need of the client, the boss, the company - whomever or whatever you work for. I meet with investment bankers all the time, evaluating investment opportunities. Mr. Pohlada and I have created a strategy about what kind of companies to buy, how we should buy, and how much we should spend. I am out there every day looking for companies to buy. I value them. I meet with management. I use all the skills that I have learned -- people skills and financial and legal skills to evaluate the opportunities. People skills are high up on the list because when you invest, you invest in people.

When I look at a company, I evaluate management. If management is lacking, I don't care what the numbers are going to say -- we won't do business with them. Of course, you do have to understand the numbers to know if they

make sense. If you don't know what to look for and at the bottom line you say yes, you're lost. If the numbers don't make sense, it tells me a lot about the credibility of the CFO.

Once we look at the numbers, we negotiate the deals. Then we buy or we don't buy.