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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.¹ 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 good odds require creative contracting, so the VC industry has responded with

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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.

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

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.²

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.

² 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

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.³

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

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 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.⁴

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 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

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

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.”⁵ 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

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

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.

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.⁶

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

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 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.

