Major Battlegrounds in Venture Capital Transactions

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Many significant controversial issues arise in the negotiations between an investor (whether a venture capitalist ("VC") or a longer-term investor such as a wealthy family) and the founders and existing management team (the "founders" or "management") of a small or medium-sized privately held business ("SMB"). The stage of the investment, the parties' relative bargaining powers, how desperately the investment is needed, how well the SMB is doing, how many other potential investors are vying for the opportunity to invest in the SMB, and the risk and reward goals and objectives of both parties will dictate which issues will likely be discussed, how they may be prioritized, and who is likely to prevail.

Obviously, the issues will vary from transaction to transaction based on a multitude of factors and warrant their own treatise. This article will only highlight those items which thrust at the very heart and soul of the relationship between the investors and the founders/existing founders/management team of the SMB and which tend to arise in practically every investment. These fundamental issues include: how much will the investor own, how will the SMB be managed, how will new opportunities be shared, how will new capital be treated and, finally, how will the investors cash out?

Many investor groups are dogmatic and inflexible about these issues and, therefore, their wishes will prevail if management has no other choice. These groups adopt the "golden rule" approach; since they have the gold, they make the rules. Most sophisticated investor groups, however, approach these issues with a great deal of sensitivity to the egos and feelings of the founders and management team. The last thing an investor wants or needs is the phyrric victory of imposing its views on these fundamental issues in a way which demoralizes, antagonizes and alienates the founders in the process. These concerns must be balanced against the practicalities that the investor needs to earn a return on, and wield a reasonable degree of control over, its investment.

1. How Much of the SMB Will The Investor Own? The first battleground in the discussions between an investor and founders of a SMB is to determine how much of the SMB the investor's investment will purchase. Obviously, the higher the value of the SMB, the less the investor's investment will purchase, and the converse is equally true. Just as beauty is in the eyes of the beholder, the value of a business may be determined through many means, some of which are objective and some are subjective. These valuation methods enable both parties to marshal arguments to support their views regarding value.

- **Investor Determination of Ownership Percentage**. Sophisticated investors typically take two approaches to determining what percentage of the SMB their investment will buy. The "inside out" approach determines what the SMB is worth and what the investment will buy. If the business is worth $1 million and $1 million of investor capital is needed, then the investor will seek a 50% ownership interest. More typically, particularly in start-up situations, the investor adopts the "outside in" approach. It applies its desired return on investment to value the business accordingly. For example, if the business is worth $1 million today, the investor

desires a 35% IRR on its additional $1 million investment, and believes the equity of the SMB will be worth $5 million in five years, then it must own 56% of the common to achieve that desired return.

Valuation Methods. Before determining what ownership percentage is necessary, the investor will first value the SMB in which it is contemplating an investment. At the risk of oversimplifying three university courses on finance, the investor will typically adopt one or more of the following basic approaches. All of these approaches must be categorized as an art, not a science. Many assumptions and value judgments are implicit in all of these methods.

Comparable Business. A first method may find the investor looking at what comparable businesses have sold for in the jargon of the particular industry, whether on a multiple of earnings, cash flow (i.e., earnings after adding back interest, taxes and depreciation expense and amortization charges ("EBITDA")), modified EBITDA (by providing for changes in working capital, capital spending, taking out or adding back extraordinary items or costs which should be normalized), multiple of book value or revenues, or some other standard formula. If a typical manufacturing business sells on a private market basis for five times EBITDA, and the targeted investment generated EBITDA of $1 million in the previous year, then a $5 million value could be ascribed. The comparable business approach assumes that businesses are comparable. Obviously, many distinctions between businesses can always be drawn. This method forms a rough basis of comparison, but is rarely, if ever, relied on exclusively.

Replacement Cost. Investors sometimes judge what it would cost to replace the assets of the targeted business. This replacement cost method addresses the perennial issue of "buy versus build". The investor adds up the sum of all of the parts -- the buildings, distribution channels, reserves, brand name recognition etc. -- to gauge what it would actually cost to duplicate the business. This method is also helpful in acting as a sanity check on the investor overpaying for an investment, since it knows that its worst case is just to reconstruct the business itself. The obvious fallacy with the approach is that putting a value on intangibles such as brand recognition, employee talent, distribution channels and goodwill is difficult if not impossible to gauge accurately.

Discounted Cash Flow/Internal Rate of Return. The most sophisticated investors will use the following two approaches. They judge the anticipated future cash flow streams of the business, unlike the first approach which looks at the past, and the second approach which looks at the present. This method attempts to estimate the future cash flow stream of the business, and discount that cash flow stream to the present by using a discount or "hurdle" rate selected by the investor. The discount rate will be higher based upon perceived risk and uncertainty that the projected results will be achieved. If the discounted present value of that cash flow stream exceeds zero, the investment makes sense.

In other words, the investor adds up its best guess of what its share of all the distributed cash flow from operations will be over the foreseeable future (say 5 to 7 years) and its share of the sale price or terminal value of the business assuming that it is sold for a reasonable market multiple at the end of that period. These cash flows are then discounted to their present value by applying a "hurdle" rate, which is the rate of return desired by the investor, or the rate needed to compensate it for the risks involved. The investor then deducts its initial investment, and

contemplated future investments, from the present value of all these future cash flow streams. If the net present value ("NPV") is positive, then the investor has earned its return and the investment makes sense. If the net present value is negative, the investor will need to reassess some of the variables in the equation.

A variation of the NPV approach is the internal rate of return ("IRR") analysis. The IRR is in the most simple form the rate at which all future cash flow streams, both outflows and inflows, discounted to the present, are zero. These approaches arm the investor with "evidence" that it needs a higher share of those future cash flow streams in order to make the net present value positive. (In recent years, savvy investors have become more discerning in evaluating a true IRR. IRRs are frequently manipulated by not including management fees charged by LBO funds, for example. LBO funds also distort stated IRRs by not counting unrealized gains, and typically losses, in the calculation. Finally, many LBO funds require investors to make capital contributions when called for, often over a multi-year period. This approach has the effect of increasing IRRs since the capital was technically invested for a shorter period when in essence the investor has truly had its capital committed for the entire time period.)

Common to approaches one, three and four is the investor's focus on and assessment of risk. Axiomatically, the riskier the perceived investment, the higher the return must be demanded. Conversely, as a business matures, or as its reliability of obtaining a certain level of operating cash flow becomes more predictable, the time and stability risk decline and therefore the return rate required by the investor declines. Likewise, as the investor's security increases, its risk decreases and therefore so does the return it can reasonably expect.

Thus, under the comparable earnings and NPV/IRR approaches, the greater risk will be reflected in lower valuations, which, in turn, will result in the need to demand higher percentage of the equity. Translating an investor's perception of risk into a framework to illustrate the impact that risk has on its investment can be simplified for a non-numbers-oriented person like the author as follows:

$$NPV = \frac{FV}{(1 + i)^{n \text{ power}}}$$

NPV	=	Present Value of all future cash flow streams
FV	=	Future Value of all future cash flow streams
I	=	interest rate
n	=	number of years

This formula shows that the NPV is a function of the interest rate and the number of years expected to elapse prior to an ultimate sale. As these numbers increase and as the NPV decreases, the value of the business decreases and, therefore, the ownership percentage the investor needs to earn on its desired return on investment should increase. An investment in a biotechnology start-up appears to be a risky investment and will therefore demand a higher interest rate to compensate for that risk and also assume a longer number of years prior to the eventual payback. Since "i" and "n" are high, the net present value is lowered and, thus, the ownership interest represented by the investor's investment increases. Conversely, a less risky

business like a McDonald's franchise might justify a lower return and a much shorter period before payback is secured. The NPV in this case would therefore be higher and the investor's ownership interest reduced accordingly.

Early Stage Valuation. Valuation of mature businesses is difficult enough. In the case of early stage SMBs, valuation becomes even trickier. The early stage SMB has no products, no cash flow, high research and development expenses, negligible assets, few if any patents and its future is predicated on hope and dreams. Valuation at this stage is perhaps the true province of the artist. However, a few approaches are common to valuing SMBs at this stage. The revenue multiplier approach simply values the SMB based on a multiple of revenues. This method is most common when the SMB obviously has some level of revenues, but is draining cash due to high ongoing research and development expenses. The modified NPV approach is also frequently employed to value SMBs at this stage, albeit applying a very high discount rate. However, this method determines the terminal value (i.e. the expected sales price at some point in the future) by using a multiple of revenues instead of earnings.

- **Founder Response to Investor's Determination of Ownership Percentage**.

Assuming the existing SMB founder has any bargaining power, sophistication or disagreement with the investor's proposed ownership percentage, the founder may offer several countervailing views. Often, the founder will attempt to debunk many of the conservative assumptions made by the investors. The founder will promise that the product will get to market quicker, find consumer acceptance faster, costs will be lower, revenues greater, and the level of certainty without question. These rebuttals attempt to lower the "i" and "n" factors, increase the net present value of the SMB and, therefore, lower the investor's ownership stake. Founders will also point out the "hidden values" that do not appear in the investor's financial projections. Many distribution opportunities have not been exploited, or certain products not fully developed, they may suggest, due to lack of capital. These opportunities, therefore, would need to be reflected in the pro formas.

A founder may also suggest that the investor reduce its risk by treating its investment as subordinated debt, convertible preferred equity or straight preferred equity and therefore having a liquidation preference over the founder's (and investor's) common equity. To the extent that the investment is truly straight preferred, and not convertible into common upon certain events such as an initial public offering ("IPO"), founders may argue that the investment is truly less risky since it will always be repaid first. Moreover, even if the investment is convertible to common, and will not have a priority over common in an IPO, that conversion occurs only upon good news such as an IPO and thus the mandatory convertibility feature is not detrimental to the investor. Further along that continuum, the founder may offer a dividend return on that preferred layer of capital to reduce the investor's risk further, in exchange for the founder retaining more common equity.

Further, a founder may imply that the proposed allocation simply does not provide sufficient incentive to the founder or the management team. Obviously, a VC, especially one investing in a management team, as much as the concept and products of the business, understands the need for motivated and incentivized management.

Finally, an founder may grudgingly accept the investor's ownership requirement, but suggest that a means should exist to prevent the investor from gaining a windfall if the projections have been too bleak, and, conversely, to reward the founders if they did a good job and exceeded the investor's projections. As discussed in Scenario 3, the founders may suggest a sliding scale whereby the investors earn a return and then ownership interests shift. This can be accomplished through an ownership document which provides for these shifting sharings in ownership, or through options granted to founders, which are triggered upon achieving certain results.

• **Synthesis of Investor and Founder Goals**. Resolution of the give and take between the investors and founders will likely be somewhere on the continuum between their respective positions. The following is a typical resolution of the investor ownership issue.

Flips in Allocations. As discussed in Scenario 3, the parties may agree that the founders receive their investment back first, and then the parties will share the remainder 80-20 (a "flip"). Four basic variations on this theme are frequently negotiated.

One variation of the flip approach is simply a straight split of the equity, and no flip is involved. In this example, the split might give the investor higher than 80% due to the increased risk from not having a preferred instrument and a lower amount to the founder since it will share in all profits right away instead of waiting for the day when the preferred equity is finally retired. If the SMB is at the start-up stage, the founders' receipt of this type of equity might considered to be compensation and therefore taxable upon receipt at ordinary income rates.

A second variation gives a coupon to the investors in exchange for a higher residual equity for the founders. For example, the investors might be entitled to a return of their capital investment plus a coupon of ten percent compounded annually. After the preferred equity and coupon are paid, the founders may then receive 30% and the investors 70% of the common. The founder's confidence in meeting the increased burden of servicing the coupon is supposedly rewarded with the increased upside potential.

Third, in the Growth-Equity Stage, a founder may observe that the SMB is already worth something and therefore it is unfair for all of the preferred equity to be represented by the investor's new investment. For example, if the SMB is valued at $1 million, and the investor is infusing an additional $2 million of capital, the founders may argue that it is unfair to ignore their existing equity. The results may be the creation of two levels of preferred, with the investors receiving their capital back first, then the founders receive a return of their capital, and then the common equity split of maybe 80% to the investors and 20% to the founders. The parties may simply treat all equity as common and adjust their splits in a 2/3 to 1/3 basis accordingly. Finally, the founders and investors may blend the existing value in the common and preferred. For example, $2.9 million may be preferred equity, split pari passu 2/3 to investors and 1/3 to founders, and then the residual common equity split of 80% to investors and 20% to founders.

A final variation repays the investors (and founders also as suggested in variation number three), then shifts the allocation in two or more (as opposed to just one) stages as set forth in Scenario 3 of the Start-up Stage. This variation provides greater incentives to the founders and

management team to achieve greater and greater results, and creates a more delicate balance between rewarding the efforts of labor and the risks of capital. A nuance involves distributions from operations or the sale of a subsidiary or line of business of the SMB. In such event, it is possible that distributions may be made at the third flip level (i.e., after the investing capital is returned and after the requisite IRR has been earned at the next level). At a later point in time, however, the SMB may be sold and the level of sale proceeds may indicate that the prior distribution should properly have been only at the second level. In such event, it is important to address whether the first distribution should have ever been made, or placed in escrow, or reinvested in the business, or whether the recipients of a distribution which turned out to be greater than the amount to which it is entitled should be required to pay it back, and if so, with or without interest.

A further nuance on variations one and four involves whether it is fair to flip the allocations, even if the investor has earned its desired IRR, if the investor has not received some minimal cash return. This issue really addresses the timing of the investment and the fact that, if a SMB is sold for a lot of money much quicker than anyone anticipated, the investors may make a great percentage return on their investment, but reap a less substantial dollar sum. For example, assume the investor is entitled to its money back, then the parties share 80-20 until the investor earns a 25% IRR and then the parties share 70-30. If the investor invests $1 million, and the SMB is sold for $3 million in one year, then investor will receive $2,431,250 (i.e., its original $1 million plus the next $250,000 representing a 25% return for 1 year on its $1 million investment plus $1,181,250 representing 70% of the remainder) and the founders would receive the rest. While that represents an astounding annual return of 143%, the cash return is far less than the three to four times return the investor typically seeks. The investor therefore frequently demands that prior to the second flip (from the 80-20 to the 70-30 stages), the investor must have received at least three times its money. In this example, the investor would not have earned three times its money and therefore the shift to the 70-30 stage would not have occurred and the investor will be entitled to an extra $168,750 which increases its annual return to approximately 160%.

• **Vesting**. An investor may agree to the flips only on the condition that the founder's rights to its increased ownership percentages vests over time and perhaps based on performance. The purpose of vesting is to tie the founder to the business for a period of time and to assure that the founder does not reap a windfall if it has not put in the required effort. Further, since ownership in the business is needed to attract, retain and motivate management, vesting serves as a basis for recovering some ownership interests from departed personnel. Those recovered interests, in turn, can be used for replacement management personnel.

A fairly common vesting schedule may be over five years at twenty percent per year. If the bulk of the hard work and effort is in the early stages (e.g., if a telephone system needs to be built out over the first couple of years before operations can begin), the vesting may be front-loaded. Conversely, if the investors believe that management's full attention is needed over the entire five years, it may backload or cliff base the vesting, so that, in the most egregious case, if the founder left on the fourth year and 364th day, its vesting percentage would be zero.

The vesting schedule typically accelerates upon the sale of the business, termination of the founder's employment with the business without cause, and death. Sometimes the

acceleration rate is 100% and sometimes a smaller percentage. Conversely, the vesting percentage is typically zero and, therefore, the flip is zero for that management team member's share of the flip, in the event that the management team member's employment with the business is terminated for cause or the manager breaches his non-competition or confidentiality covenant.

A founder may argue that the concept of vesting is unfair since no correlation exists between time and ability to return the investor's investment. Even if a correlation does exist, the founder's argument continues, this is embodied in the shift in the allocation formula. In other words, if the founders have performed so well that the allocation formula has already shifted to the third layer, why should the investors care if this shift has occurred in a short period? A vesting schedule in this case would actually encourage management to delay causing the business to succeed. This concern may be more theoretical than real. As a practical matter, distributions are unlikely to be made from most businesses in the early years (and if distributions do occur, they most likely will be insufficient to pay off the investor's initial capital). If distributions are made, they will likely be as a result of a sale, and in that case, the investors are usually fully vested.

• **Clawbacks**. Despite all the best of intentions and grandiose ambitions, projected results are sometimes not achieved. While performance failures raise governance issues (see below) and sometimes affect vesting (if vesting is performance based), investors will sometimes want the right to reduce the founder's splits if certain events do not occur. For example, if a budget is not met, projected levels of cash flow do not materialize, or a certain sales level is not achieved, the investors may want to "clawback" the founder's residual common equity split from 20% to 10%. Since results were not achieved, investors believe that the founder's sharing in further upside is unfair.

The founders may respond that failing to achieve certain numbers may be based merely on timing disparities, or may be due to macroeconomic conditions far beyond anyone's control. Further, if the allocations are structured to require a certain IRR before the founder may attain the next level, the business' shortfall will already penalize the founder. Therefore, founders maintain that they should not be penalized for these shortcomings.

The parties may ultimately agree to some form of clawback. However, the founders will try to build enough cushion into the performance targets to only be penalized in a real disaster, in which case the founder's equity's value is already in question. Further, founders will want the right to recover the clawbacked interests in the event the business subsequently performs well and earns the investor its desired return.

2. Governance. Management of the day-to-day operations of the SMB as well as decisions on fundamental issues present a frequent source of tension between investors and founders. Control issues vary dramatically based on the size and stage of each investment. This article will focus on the most difficult situation from the founder's standpoint -- an Early Stage investment by an investor in the SMB where the investor has the lion's share of the common equity. Many investors, consistent with their voting position, demand full and untrammelled right to select the members of the Board of Directors (the "Board") and authority over each and every decision, no matter how small or how significant. If the investor's investment is held in a convertible debt instrument, however, the investor may be cautioned not to exert this amount of

control. In a bankruptcy situation, other creditors may succeed in equitably subordinating the investor's debt on the grounds that it exerted the control of an equity owner.

The founders may try to negotiate some meaningful role in addition to their positions as employees of the business. A management role is necessary to impart their knowledge and experience in the business, as well as have some control over their destiny. This ability to have substantial control, at least over operations, is especially important in cases where a clawback penalty looms. To suffer a clawback when the management team is hamstrung by budgets and financial conditions unilaterally imposed by others seems unjust.

The negotiation process usually results in a multitude of compromise governance structures to reconcile the investor's goal of complete domination with management's desire for meaningful input. An approach which moves away from the sole investor control position on the continuum constitutes the Board with seven members, four from the investors and three from the founders. Founders may provide their input at Board meetings, but ultimate control rests with the investors.

Moving further down the continuum from total investor control, some Board decisions may require the assent of at least five directors and thereby afford the right of management to block an investor action. The items over which a founder would expect to see this type of input are operational issues such as approval over budgets, giving raises and bonuses, and changing operating strategy. Structural issues such as sale, raising of capital and similar items however, remains in the majority (i.e., investors) of the Board.

Super-majority consent may be further required for major structural decisions such as bank borrowings, major capital spending, raising of additional capital and ultimate sale of the business. A nuance of this approach provides a supermajority requirement in the first few years. After that time, or after the time that certain financial performance goals are not met, however, Board control may revert entirely to the investors.

Continuing down the control spectrum toward management control is the situation where the budget is devised by the founders and ratified by the Board. Moreover, day-to-day decisions may be made by the founders, subject to the parameters set forth in the operating and capital budgets.

A final stop along the control continuum might be a neutral Board. The investors select three, the founders select three, and a distinguished member of the industry is selected by the six members as the seventh member of the Board. Further, the company's charter may reduce the number of Board seats allocated to an investor as that investor's ownership interest is diluted in subsequent financings. As this percentage is reduced, investors may ask for honorary, advisor or observer seats, which allow them to attend Board meetings and obtain materials circulated to Board members.

3. Additional Capital. Most SMBs, whether they grow or lose money, continually need to raise new capital to exist. A growing business needs new capital for expansion and to finance working capital. A business suffering losses needs to fund those losses. Very few

businesses are fortunate enough to internally generate sufficient free cash flow to cover all operating and capital needs.

Investors and founders tangle over the degree of investor protection in the event of additional rounds of financing. Investors typically demand protection against "dilutive" financings. Since any sale of additional ownership interests to a new investor group reduces the initial investor's claim to the company's assets and income stream, the broadest concept of dilution would render every financing dilutive. A more benign and practical view of dilution is to treat a financing as dilutive if it negatively impacts on the measure of a business' value. If the value of the business is measured by earnings or book value, then financings reducing those elements are dilutive. For example, assume a business is valued by its stockholders' equity and that account is $1 million, with A and B owning 50% each. If C buys 25% of the common equity for $250,000, that purchase is dilutive since $250,000 should have purchased only 20% of the business.

With the caveat that the investors will follow the "golden rule" (i.e., he who has the gold makes the rules), the following addresses ways to reconcile investors' concerns with dilution while preserving the SMB's ability to raise additional capital. Assume for this discussion that the investor has initially purchased convertible preferred stock at the Seed Money Stage with a conversion price of $2 per share. An additional round of financing is then proposed for $1 per share. Assuming the investors cannot control the terms and conditions of this financing by virtue of its control of the Board (or if they do control the Board, take pains to discharge their fiduciary duty to the other shareholders), what rights should the investors have to protect their investment? Assume further that the investors summarily dismiss the founders' view that while dilution technically reduces the investors' ownership interest, the new capital will be used to accelerate earnings growth far in excess of any level ever forecasted by the investors when they made their initial investment and, therefore, economic dilution will not occur. In other words, the investor will own a smaller piece of a bigger pie.

• **Pre-Emptive Rights**. Investors invariably receive the right to purchase the number of shares necessary to maintain their percentage interests in the business. While the right may be nice to have in theory, in actuality the investor's appetite or capacity for additional investments may very well be sated by the time additional equity is being raised. These rights typically terminate upon an IPO.

• **Full-Ratchet Method**. The harshest and most punitive investor protection method essentially converts (or ratchets down) the investor's conversion price to the new lower price. A draconian example illustrates the point. Assume the investor owns 100,000 shares of preferred stock, convertible into 100,000 shares of common stock at $2 per share. The founders own 100,000 shares of common stock of the SMB. If the SMB needs an additional $10,000 of capital and the investors price this additional round at $0.10 per share, then the SMB would issue 100,000 additional shares to the new investor. The founder's stake in the SMB has thus been reduced from 50% to 33-1/3% due to only a $10,000 investment by the new investors. Further, the investor's conversion price has been reduced to $0.10 per share and thus saves the investor (and costs the company) $190,000 upon conversion. Theoretically, even if just one share of new

stock were issued at this price of $0.10 per share, the investor's conversion price could have been lowered to the new offered price.

• **Weighted-Average Method**. A fairer approach also reduces the investor's conversion price to a lower number, but that lower number depends on the number of new shares issued, and price per share, in the subsequent offering. For example, assume that a SMB had 200,000 issued and outstanding shares (including the investor's 100,000 of convertible preferred) prior to the new offering, and the investor's initial conversion price was $2 per share. The SMB issued 100,000 additional shares to a new investor at $0.10 per share raising $10,000 in new funds. The initial investor's conversion price would therefore reduce from $2 per share to $1.34 per share determined as follows:

((X + Y)/(X + Z)) multiplied by Old Conversion Price

where X = the number of issued and outstanding shares before the new financing (i.e., 200,000)

Y = the number of shares which the new financing would have purchased using the original higher conversion price (i.e., $10,000 would have purchased 500 shares at the original per share price of $2 per share)

Z = the number of shares actually issued as a result of the new financing (i.e., 100,000)

Investors are careful to assure that this formula applies only if subsequent rounds of financing are at lower prices, thus locking in their low price per share. Complications arise with warrants and options, as well as with subsequent rounds of financing with prices then between the original and new price, or with options taken into account in "A", but then unexercised. Careful drafting should also exclude from this formula shares issued for employee options and due to a merger.

• **Play or Pay Method**. Some founders detest the apparent unfairness of the investor receiving the downside adjustment of its conversion price with no risk or obligation to participate in the subsequent round. The founder with significant bargaining power may require the investor, therefore, to exercise its pre-emptive rights in order to avail itself of the dilution protection. Some "pay or play" provisions actually require the investor to convert its preferred shares to common at the higher original price if it refuses to participate in the new round of financing.

4. New Opportunities. In many SMBs, the investors try to insure through proper documentation that the founders and/or management team is "lashed to the mast". Slavish full-time devotion to the SMB by management and pure focus on the business at hand are critical to give the investment the opportunity to pay off and prevent the founders and management team from bailing out and pursuing more lucrative opportunities at the first sign of trouble. A failed investment will not impact on the management team financially as it will inflict economic loss

on the investors. The experience of running even a failed SMB may actually help build the founders' credibility and resume as it seeks to form new ventures.

Founders, on the other hand, desire more flexibility to pursue other ventures either in the same industry or in unrelated fields. Founders reason that as long as they are devoting sufficient time to the SMB, they should be free to pursue other opportunities in related or unrelated fields. For example, in a computer software SMB formed to develop banking transaction software for electronic funds transfer, the founders may desire to start another SMB developing software for analyzing credit card debts as long as they oversee the SMB's programmers who create the software, and are standing by ready to market and further develop the software once it is commercially available. In a paging SMB located in one state, the founders may desire to start or acquire another business in another state once the original business is operational and meeting or exceeding projections. The founders often feel their obligations on behalf of the original venture are satisfied if they have instilled that entrepreneurial vision and assembled all of the necessary financial, operational and research pieces to make that business work. Their creative energies, they argue, should not be stifled while they wait for others to execute their vision.

Investors react in several ways to management's desire to have more flexibility and freedom to pursue other opportunities. These reactions also span a wide continuum. At one extreme, the investors will require the management team to spend all of its business time and energy on the SMB, at least for the duration of the employment agreement and vesting periods. This position is probably the most common.

The investors may agree to commit additional funds for investments in the same industry to build the SMB and give it substance. In the example of the paging business, the founders may have agreed to accept capital from the investors to acquire the Minnesota business for $10 million, only on the grounds that the investors shared the founder's concept and vision to grow the SMB through acquisitions of add-on businesses in contiguous markets and to geographically diversify the business through acquisitions in other areas. Therefore, the investors may agree to commit an additional $20 million for these types of acquisitions, provided that the new transactions meet their financial and operational requirements. This commitment for future capital therefore quenches the founder's thirst for pursuing these opportunities yet, at the same time, justifies the investor's insistence that management focus solely on the SMB investment.

A founder team (in a stronger bargaining position) may still desire greater flexibility to pursue other opportunities. In this case, the investors may agree to let the founders pursue these other opportunities on several conditions. First, the new opportunities cannot be competitive with the existing SMB. In the case of the paging business, therefore, the new opportunity can be in Texas since this market does not compete with paging businesses in Minnesota. The new venture cannot be in banking software, however, since this product has worldwide utility.

A second condition to releasing founders from the investor's typical requirement that founders devote all their time and effort to running their business is that the founders spend at least the amount of time necessary and proper to assure that the business model is being implemented. While these concepts are not capable of being objectively quantified by specific time or financial performance thresholds, these terms convey the sense that the SMB at issue should initially command the founders' substantial focus and priorities.

Investors will also seek the right, not the obligation, to participate in the new opportunities. If the investors do choose to participate, the battleground is whether they will invest all required capital or just a portion of the required investment. If the investors desire to invest just a portion of the new investment, a minimum portion is typically expected just to show the seriousness of the initial investor. A further complication arises regarding whether the new opportunity should be melded, legally, or operationally with the initial SMB. This, in reality, requires all investors, new and initial, to agree on a valuation of the existing SMB to give proper credit for any appreciation in the initial investor's investment, and to agree on a governance structure which shares the investor authority between the initial and new investors. A final nuance involves the allocation of the right to participate in the future between the initial and new investors. Is it on a basis proportionate to the initial investments, on the value of the initial investment at the time of the new investment, or is there a first priority given to the investor in the industry or geographic area which is closest in kind to that investor's investment? For example, if the initial investors invested $10 million in the SMB in the paging business located in Minnesota, the new investor group invested $5 million with the founders in a paging business in Oregon (in which the initial investors chose not to participate and not to blend in with the Minnesota business), and the Minnesota business was worth $15 million at the time of the Oregon investment, how should a new opportunity in a paging business located in California (which is considered to be contiguous to Oregon) be offered to the initial and new investors? Should it be offered at all? Should the Oregon investor group have the entire right to participate since the new opportunity is contiguous? Or should the Oregon investor group get the first right to participate? Should the Minnesota and Oregon investors split the right to participate on a basis of 10/15 to the Minnesota group and 5/15 to the Minnesota group (the ratio of the original investments) or should it be based on 15/20 to 5/20 (the ratio of the original investments marked up to market value)?

5. Exit Strategies. The investor's attitude regarding the ultimate disposition of the investment varies based on the nature and risk tolerance of the investor. As previously mentioned, most VCs have a five to seven year time frame in which they expect their investment to remain outstanding before it is monetized. Of course there are notable exceptions, such as the original VC investors in Intel and Compaq Computer.) This relatively short time horizon is dictated by several factors. Investors in VCs and other institutions also demand a payback in a relatively short period of time and therefore the VC is merely expressing the needs and demands of its clientele. As the NPV formula illustrates eloquently, the longer the period that the investment is unreturned, the greater uncertainty arises and therefore the greater return is essential. Further, given the discounting factor of dollars in the future, large sums of money realized many years out in the future are not worth as much as they seem. Finally, as time elapses, management and industries change to the point that the investment takes on a completely different character and form.

Many institutional investors may tolerate a longer holding period based on the nature and quality of the investment. Pension funds and insurance companies, whose obligations to beneficiaries extend for decades in the future justify holding an asset like a stock that far in the future. Insurance companies, as taxpaying entities, have to be concerned with paying significant capital gains taxes on long term holdings. The implied tax liability to Berkshire Hathaway, for

example, based on its current gains in Coca Cola, Gillette, Washington Post and Disney is in the billions of dollars.

Hedge funds, on the other hand, rarely hold investments for long periods. Disciplined hedge funds, while speculating on risky speculations, will cut their losses, or take their profits and run.

A blueprint to ultimately dispose of the investment, therefore, is a major priority of investors and is a prominent topic during the negotiations. This blueprint for the investor's ultimate exit takes several forms.

• **General Transfer Restrictions**. Investors want to assure that the founders will not be able to freely sell their shares in the SMB. If the founders are financially "joined at the hip" with the investors, they will stay focused and motivated. The founder's may agree to these restrictions for a certain period of time (three to five years), but after that time elapses, be permitted to sell to any third party. Investors may not want any restrictions on their own ability to sell any shares at any time, but may have to agree not to sell their shares for the same reasons they wish to prevent the founders from selling their interests.

• **Drag Alongs/Tag Alongs**. After the expiration of any holding period which prohibits an owner from transferring its shares, sales within the investor group are typically offered to the other members of the investor group first and then offered to the founders. The founders may claim that their ability to purchase the investor's shares is illusory since the founders do not have a realistic access to capital to acquire the funds. The investors reply that this fact should not preclude their ability to sell and should not harm the founders, since in substance one financial founder is merely being replaced by another. Whether this view is true depends in part on the degree the selling investor participates in or actually controls the SMB.

Since the investors do not own all of the SMBs' securities, their efforts to sell the SMB may be thwarted if the third-party buyer desires to purchase all of the SMB stock. Therefore, investors typically require the right to cause the founders' shares to be "dragged along" and sold to the buyer at the same price if either the buyer requests or the investor believes that the sale of all of the stock will enhance the prospects for sale of the SMB. Founders, on the other hand, may desire to sell their shares to the buyer at the same time and price as the investors. Founder's rights to "tag along" is generally acceptable to investors on two conditions. First, the tag along (or piggyback) right is not considered if the buyer genuinely would not buy the SMB unless the founders maintained their same ownership interest and the same motivation inherent in ownership of a business. This concern is only rarely voiced by a buyer and many avenues pave the way to address this concern, including selling some of the founder's stock and rolling the balance over on a tax deferred basis into the buyer's entity, giving options to founders to buy stock in buyer's company, or selling them some stock in the buyer's company. A second issue arises in poorly drafted "tag along" clauses. Frequently these clauses simply allow the founders to sell on the same basis as the investor. If the investor desires to sell all of its stock, which represents 80% of the SMB's stock, does this tag-along right therefore mean that the investor can still sell all of its stock and the founders also have the right to sell all of their stock? Or does this mean that the investors may now only sell 80% of their shares (64% of the SMB total outstanding shares) and the founders may only sell 80% of their shares (16% of the total SMB

shares) to give the buyer the desired 80% of the total stock in the SMB? These clauses frequently do not address the ramifications of the buyer refusing to proceed with the transaction if, in the first scenario, the buyer is forced to buy all of the SMB shares and aborts the transaction as a result.

• **Right to Cause a Sale**. A common exit strategy affords the investor the right to cause the business to be sold or merged. Investors typically demand this right which they can exercise at any time. The parties may agree that some time should elapse before this right could be triggered in order to give the founders a chance to implement the business plan. In lieu of tying the right to cause a sale to a specific time period, some agreements require the occurrence of some event such as a deadlock on major issues, failure to achieve targeted financial goals, or the departure of a key founder. Sometimes, the parties agree to give either party the right to sell the business at any time, or after a certain time, for a price not less than an appraised or agreed to minimum value. The other party would then have the right to match that price prior to the time the business is marketed for sale. While investors desire the flexibility to be able to cause a sale of the stock or assets of the business at any time, the founders will want to limit the periods during which the business is being shopped. This reduces the negative impact on employee and customer morale and uncertainty that naturally occurs during the sale period.

• **Rights of First Refusal, Offer and Negotiation**. To achieve the goal of maintaining continuity of ownership and inter-founder relations, one party frequently gives the right of first refusal to the other party prior to the sale of their stock or the sale of the business. This right allows the non-selling party to match a bona fide arm's length offer made by an independent party. Since this offer is from an unrelated third party, it is thought to be for a fair price. If the selling shareholder is offering an unreasonably low price to the third-party buyer due to the seller's personal circumstances necessitating the sale, the other shareholder can reap this benefit. If the price the third party is willing to pay is very high, the non-selling shareholder can avail itself of a tag along right, or, in some circumstances, cause the conversion of the selling shareholder's interest to be non voting.

Many object to the concept of a right of first refusal on the grounds that it may have a chilling effect on would be purchasers. The third party offeror's enthusiasm is repressed by in effect not knowing whether its deal will be consummated. Third-party offerors also resist acting as the stalking horse to set the price that someone else can match.

To address the concerns that rights of first refusal may have the practical impact of reducing the universe and attractiveness of potential buyers of privately held stock, some shareholder agreements provide for rights of first offer and first negotiation. A right of first offer essentially requires the selling shareholder to first make an offer to the non-selling shareholder at which price the selling shareholder would be willing to sell its shares or the entire business. If the non-selling shareholder does not wish to pursue this opportunity on these terms, then the selling shareholder would have a finite period of time to market the shares or business. If the selling shareholder found a buyer within this time period for a price equal to or above the offered price, then the sale could go through. This approach enables the non-selling shareholder to assure that the price is fair and that it has had an opportunity to participate in the purchase. It also allows the selling shareholder to pursue the sale without the specter that the would-be buyer

will be discouraged by the existence of the right of first refusal. The time period during which the shares or the business must be sold at or above the offered price should be kept relatively short (e.g., not more than six months). This minimizes the psychological and logistical impact of having the business or large block of stock being perpetually up for sale. The right of first offer should also adjust for the circumstance where the buyer's price is ultimately reduced below the offer price (e.g., due to a purchase price adjustment between signing and closing caused by losses or declining levels of working capital). A modest, let's say 5% reduction, below the offer price is generally accepted as reflecting the realities that the business can deteriorate by some amount without starting the entire right of first offer process over again from scratch.

Some investors believe that a right of first offer also has a chilling effect on would be purchasers due to the many timing and price caveats contained in first offer provisions. For example, the possibility that the value of the business may decline and thus reduce the sale price below the offer price, or the closing may be delayed due to financing or regulatory reasons and, therefore, the process must be re-commenced, may serve to dissuade many buyers from trying to buy the shares or business. Therefore, some agreements only require the parties to negotiate in good faith for a finite period. If the right of first negotiation does not result in a binding agreement within a finite period, then the selling party is free to sell for any price, even a price below the previous negotiated price. This approach provides the selling shareholder with the most certainty that the sales efforts will not be impeded by the other shareholders' rights. Considerable subjectivity, however, regarding the standards of good faith negotiation abound and the threat of litigation over this issue could loom large. The ability to negotiate in good faith with parties with whom distrust or antagonism may be present is also difficult.

• **Put/Call Rights**. Investors may seek rights to require the business to purchase their shares (a "put") as an exit strategy. The put may be triggered upon the lapsing of time or the occurrence of deadlock or failure to meet targets. The put price could be either the liquidation value of the preferred equity of the investor and some sort of formula or appraised value for the common equity. While a formula value is sometimes used (e.g., eight times trailing net earnings), this method can be dangerous since fair and appropriate formulas vary over time and the current risk profile of the business. The put is also of questionable value on a real practical sense. If the business is doing well, the investor has other means available to it to liquefy its position. If the business is doing poorly, the business may not have a means of financing the put, and therefore, the impact of the put is to convert the seller's equity to the right of an unsecured creditor.

Some businesses extract a right to purchase (a "call") from the investors as the logical mirror of a put. The pricing and terms of the call may be the same, except the call right is usually delayed for a year or two after the time that the investor is first able to exercise the put. The value of the put, moreover, may be discounted by a small percentage, say 5%, as the price the investor is willing to pay to gain cash. Conversely, the call may carry a 5% premium (or perhaps a premium which declines over time) to compensate the investor for having its interest redeemed involuntarily. Investors resist calls since they put a ceiling on price appreciation. The company responds that the call is a last resort after the investor has had the right to put the stock. The call treats the investor fairly, moreover, since the price of the preferred is fixed and the value of the common will be fair market value. In the case of convertible preferred held by the investor, the

right to call the investor's shares, further, gives the company the ability to require the investor to "put up or shut up" by causing the investor to decide to either convert its preferred to common or suffer a call.

Founders may also ask for puts (and expect calls) in some circumstances. Death, disability and termination of the founder's employment with the SMB without cause are frequent triggering events. In the event that the founder is terminated without cause, the founder may also seek a right to revalue its put/call price if the company were sold for a higher price within a one to two-year period. This revaluation right keeps the company honest and prevents it from terminating the founder prior to a contemplated sale.

Finally, payment terms for the puts and calls are essential. If the company cannot afford, or does not desire to use, cash, it frequently has the alternative to defer payment. The payment period for repayment is usually two to three years shorter with a call (since the company initiated the call) than with a put. The interest rate may also be higher with a call than a put. Granting security to the redeemed shareholder, except for a security interest in the shares being repurchased, is rare. Limiting payments under a put to some percentage of the company's net cash flow should also be considered to assure that the business can still operate and will not be unnecessarily burdened by the put or call. Finally, acceleration in a sale or change of control should be expected.

• **Registration Rights**. A final, and often ultimate, exit strategy of the investor is the right to demand that the company register their shares on the public market. These rights will be documented in a hotly contested registration rights agreement. Ironically, these agreements are usually either negotiated with the fictional and absent "future underwriter" in mind or actually subsequently changed by the underwriters who have a substantial role in determining the marketability of the shares.

Investors desire the right to demand registration of their shares at any time, regardless of whether the business is then public or is planning an IPO. Like the right to sell the business at any time, investors feel they need this flexibility to ultimately monetize their investment independent of the company's perhaps countervailing wishes.

The founders typically respond that the ability to demand registration at any time under any conditions gives too much power to investors and evinces little support and conviction in the investment. At the first sign that the business is doing well, investors could exit. Further, the right to demand registration prior to the company's IPO sends a message to the marketplace that the sophisticated investor group smells trouble and wants out, thus imperiling the ultimate IPO.

• **Pre-IPO Demand Registration Rights**. Many compromise positions reconcile the parties' conflicting goals. A common approach affords an investor or group of investors the right to demand public registration of the company's shares, even before an IPO, if certain conditions are met. A certain percentage, usually fifty to seventy-five percent, of the shareholders must join in the demand. This assures solidarity of the investor group for this major event. The amount which the underwriters believe will likely be raised must exceed a threshold, typically $10 million to $25 million.

As a tradeoff for the right to cause a sale of their shares or the company's shares under an IPO, the investors are required to accept underwriter marketing restrictions on the time and manner of sale of the shares. These underwriter cutbacks and lockups defer to the underwriter's purported superior knowledge of the marketplace and their view regarding the best way to price and market the shares. Underwriters frequently restrict, if not eliminate, the right of the investors and founders to sell on the IPO and for a finite period, typically ninety to one hundred eighty days after the IPO. The underwriters believe these restrictions show confidence in the company to the marketplace. The restrictions further prevent an overhang of supply of shares desired to be sold, which supply will depress the share price. Further, if the underwriters do permit investors and founders to sell some of their stock on the IPO, they may reduce or cut back the number of shares permitted to be sold if market conditions so dictate.

Some savvy observers question the actual need for a registration rights agreement from the investment perspective since the investor in effect controls the SMB and, therefore, the investor is submitting itself to underwriter cutbacks and lockups in advance and having received in return nothing more than that which it could have caused the company to do by virtue of its control over it. The cost of cutbacks and lockups could be considerable. If the investor bought its shares initially at $1 per share and the company went public at $15 per share, the investor typically believes that it has more downside risk in delaying its ability to sell than upside potential afforded by the underwriter's delay. Even absent an agreement, the underwriter could certainly strongly recommend a cutback or lockup. In that case, however, the investor's bargaining power would be enhanced by virtue of not being bound to submit itself to such a cutback or lockup. Nonetheless, registration rights agreements are a frequent item on the investor's checklist of conditions to its investment.

If investors are not given the right to require an IPO at any time, or upon meeting certain conditions set forth above, then they will attempt to receive a right to demand an IPO after the passage of a certain amount of time. If the company has not registered for an IPO within three to five years, then an investor will want the right, notwithstanding any dollar or size restrictions, to market the company or its shares by way of an IPO. While this right sounds helpful, it too may be hollow. If the company is doing well, it may have already gone public or be generating sufficient cash flow to buy back the investor's shares. If the company is not doing well, the ability to dump its shares on an unwitting public is doubtful.

• **Post-IPO Demand Registration Rights**. If the company's shares are already public, the investor may have anywhere from one to an unlimited number of demand registration rights, subject to a multitude of restrictions. The investors and founders will, absent an agreement to the contrary, be able to sell their shares, even if they are not registered, under Rule 144 or perhaps through a Reg D or Rule 4 (1-1/2) private offering. The Rule 144 safe harbor specifies the manner in which shares held by founders and investors may be sold in the open market. If the investor or founder is no longer an "affiliate" (i.e. a director, key employee or owner of in excess of ten percent of the voting stock), their restricted shares may be sold to the public without any restriction in "dribble out" amounts in a broker transaction if the company is public and the shareholder has owned the shares for at least one year. These "dribble out" rules limit the number of shares which can be sold to, in any three month period, the greater of one percent of the company's outstanding shares or the average weekly reported trading volume for the four

calendar weeks preceding the filing the required notice of sale. These restrictions are removed two years after becoming a non-affiliate. If the investor or founder is still an affiliate, it may sell its shares with the same restrictions as a non-affiliate, except that the affiliate remains encumbered by the dribble out restrictions even after the passage of two years.

Some registration rights agreements also require a public company to file a "shelf registration" and to keep the registration statement effective for nine (9) or so months. This shelf registration gives shareholders with restricted unregistered shares the right to sell the rest of their shares in a straightforward manner, without the Rule 144 restrictions.

Demand registration rights will be restricted further by the company in certain circumstances. To comply with securities law requirements regarding full disclosure of material events, the Board may have the right, if not the obligation, to delay the exercise of any demand right if the company is undergoing material events. For example, if the company is in the middle of a significant acquisition negotiation, or is suffering a financially troubling quarter, the Board may believe that the disclosure required by a subsequent public offering (a "secondary offering") may hurt the company's business and stock price. The Board's ability to delay exercise of these rights is typically limited to a 90 to 120-day period and no more than two such periods during any one year.

Once the company is public, the investors and founders are typically afforded an unlimited number of rights to sell at a time when the company is engaging in an additional sale of its shares. These "piggyback" registration rights are also subject to underwriter cutbacks and lockups. They also typically prioritize the relative rights of the shareholders who are availing themselves of the piggyback right. For example, if the underwriter chooses to reduce the allotted number of shares which the investors and founders may piggyback, the shares may be cut back pro rata, or based on who first initiated the piggyback request.

• **Expenses**. Although the company may require the requesting party to pay for registration expenses, most of the costs of registration rights are borne by the company. The legal, accounting, brokers, underwriting discounts, blue sky registration, printing and other related costs is therefore absorbed by the company notwithstanding its mere acquiescence with the IPO or secondary offering. The cost of counsel for the selling shareholders is typically limited to the cost of one counsel selected for the entire group. The cost of any disclosure relating to a particular selling shareholder is usually borne by that shareholder. If the company needs to do a complete new audit since its last audit is not sufficiently current (i.e., it should not exceed more than 134 days old), that cost may be borne by the requesting shareholders. Sales commissions and other expenses unique to the selling shareholder are paid by that shareholder. The selling shareholder will also pay for, and indemnify the company for, any misrepresentations made by that shareholder regarding the shares or the company.