

## Why Venture Capitalists Are Using Tough New Tactics Negotiating Term Sheets, and How You Can Level The Playing Field.

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The San Francisco Chronicle recently published an article by Carol Emert that I have excerpted as follows:

*“Livemind Inc., a San Francisco wireless startup, is facing a mass defection by employees who claim that venture capitalists are making off with an unfair share of the company's equity and leaving them with virtually nothing. ...most of Livemind's staff of 35 to 40 stayed home yesterday, jarred by the firing of (the) CEO...and (the terms of) a related controversial bridge loan proposed by the VC firm.”*

The primary investor ... was demanding a “liquidation preference” of four times its money back for a proposed \$3 million bridge loan, according to sources who have seen the term sheet. Liquidation preferences give the holder first dibs on any proceeds from a sale, so the investor would reap \$12 million from its \$3 million loan.

"I was given a sizable amount of equity which is now not worth anything," said Iain Scholnick, Livemind's chief technology officer. "Eighty to 90 percent of the staff's not going (to work) and I'm not going in," said Scholnick, who was the No. 2 executive until yesterday."

This is scary stuff! It's like the old medical “cure” of bloodletting; for many ailments, the treatment was worse than the disease. What can we learn?

I am a venture capitalist, not an attorney. In preparing for this discussion, I consulted with a “blue ribbon” panel attorneys, including: Michael Sullivan of Cooley Godward in San Francisco, Cheryl Reicin of McDermott Will & Emery in New York, Joe Bartlett of Morrison & Foerster, Alex Lynch of Wilson Sonsini, Jeff Zimman ex Cooley, now Lazard Freres, Michael Collins of Testa Hurwitz, David Soren of Hale & Dorr, Phil Zender of Squire Sanders & Dempsey, and Bruce Taragin in my own firm.



## How did we get here?

Last half of 90s was a sellers market in which deals were increasingly overpriced and under-investigated.

Investors were:

- impatient
- inexperienced
- overconfident

Today is a buyer's market:

Many investors are 'once burned, twice shy'

Around Sand Hill Road (address of many VC firms) one joke is that there a lot of folks with deep pockets and short arms. These days, lawyers describe some of their own VC clients as: "nervous, freaked out, wounded, paralyzed, vengeful, nasty, overreaching" How the mighty have fallen!

Today too many VCs are seeking protection and retribution in new term sheets with, onerous, almost 'angry' clauses. To paraphrase Queen Elizabeth I, anger makes men witty, but keeps them poor.

Before we rush to tighten terms and demand 4X liquidation preferences, full ratchet anti-dilution clauses, let's recall master strategist, Augustus Caesar, who said, "Hasten slowly".

Ladies and gentlemen, we have an epidemic and to make a bad pun, we can say we are facing widespread Down Rounds Syndrome. There are many gravely ill patients, but what we really need is preventative medicine.

Entrepreneur's lessons:

- be realistic to get funded at market clearing price
- be conservative (avoid hype)
- be credible (from Missouri – show me)
- be cost conscious (tighten budgets)

Remember that in good markets single founder/CEO ends up with 5-15% pre IPO, and 1-3% in down markets after all rounds and dilution. Low initial valuations do not hurt the founders if the company ultimately becomes very successful.

Example: In 1994/5, Blumberg Capital provided extensive hands-on operations support in business development, marketing and PR in the US and Japan during the initial 18 months of life for a three person start-up security software firm from Israel. At



inception, the three founders sold 50% of the equity for \$200K in seed financing. Today, Check Point Software is a world leader in network security products and is quoted on NASDAQ at roughly \$10 billion. The three founders are each worth hundreds of millions.

### **VC lessons:**

Many of the heavily invested VC funds are in serious triage mode. Our VC industry in general should issue a collective mea culpa. VCs overpaid, were hasty, careless, and lacking in humility.

#### Message:

- Triage
- Salvage
- Back to classic venture capital formulas.
- Caution
- Karma – what goes around comes around, so be careful whom you crush.

Michael Collins of Testa Hurwitz counsels seeking reasonable balance between stakeholders, optimal discussion, transaction transparency, open information, and processes for dispassionate decision making.

Cheryl Reicin of McDermott Will & Emery says, “I recuse myself should be on lips of more VCs directors making down round financing decisions”. Remember that investors face a significantly higher fiduciary responsibility to the company, as directors versus shareholders.

Personally, I think many deals were over financed. VCs are paid a management fee on capital under management and so there is a natural tendency to raise ever larger funds, resulting in hefty management fees to the partners. With pressure from Limited Partners to deploy capital with dispatch, many VCs invested too quickly and pressured entrepreneurs to take more money, to scale faster, to increase budgets and spend more. Back in the old days (70’s through early 90’s, we learned that bootstrapping, and fiscal restraint are good disciplines. The easy cash was too much of a good thing. My first VC mentor Fred Adler says, “The size of the start-up CEO’s office is inversely proportional to the future success of the company.”

#### Lessons for Angel Investors:

- Early stage technology investing is a tough business.
- Low odds of success.
- Serious or full time commitment required.
- Wide range of professional skills demanded.
- Diversification is critical part of the equation, not easily accomplished by angels.



Moreover, deep pockets are needed to invest in winners through subsequent financing rounds.

#### Message for Angels:

- Proceed w/ caution.
- Know your limits.
- Invest through VC funds to achieve more diversification, use co-investment rights to leverage skill-set and resources of a professional investment team.

#### Strategic Investors:

There was too much of “tail wagging dog” whereby a large corporation tried to invest in start-up firms hoping in turn to build clients for the investor corporation’s products. That plan hasn’t generally worked very well because the corporate investors didn’t bring the early-stage, financing and recruiting expertise nor did the managers have the long-term perspective traditionally required for this asset class investment. I recently heard about one large software company VC fund in Silicon Valley where of 31 investments, 27 are dead or on life support. Moreover, diversification is at risk when strategic concerns overtake financial return, and most cases the risk of putting all eggs in one basket by investing in one market segment, is not compensated by the “synergy” within the portfolio. Again, investing through independent venture capital firms is probably a better route for most corporate investors.

#### It is not all bad news:

Investing in technology VC funds or start-up companies now? Who would recommend that now? Well, as Mark Twain said about Wagner’s music, “It’s not as bad as it sounds.”

Newly formed, early-stage VC funds (like Blumberg Capital ;- ) have advantages:

- 1) no legacy portfolio in need of repair
- 2) partner time available to help portfolio companies
- 3) dramatically lower valuations abound
- 4) moving back to boring Eng/PhD vs. MBA deals – just what we like
- 5) Early pick of the litter – then feed second round deals to larger established VC firms

So what are the leading legal practitioners prescribing today:

Joe Bartlett, of Morrison & Foerster is creating a site, [www.vcexperts.com](http://www.vcexperts.com) that is a threaded discussion group about these topics. I urge you all to check out the site. Joe has practiced corporate law for 40 years and he says most of this is not new at all. The same cyclical process has played out about 5 times in the last 40 years, first in the late 60s, then the mid 70’s, the early and late 80s, and today. This time, because



information technology and venture capital backed companies are so much larger as a portion of the economy, there are more echoes that continue to reverberate negatively.

### **A) Down Financing Rounds**

Michael Sullivan of Cooley Godward in SF, recommends the following for down rounds:

- 1) Offer all classes of shareholders the right to participate (except for unaccredited investors as that can create SEC problems).
- 2) Gain approval of objective shareholders or disinterested BoD members.
- 3) Obtain a fairness opinion or outside valuation, subject to cost and time constraints.

Sullivan notes that if a financing transaction is challenged in court (generally Delaware and CA), the burden of proof is on the insider investors who benefited from the down round.

Joe Bartlett recalled that in 1989 First Boston was getting out of the VC direct investing business and two large, well known VC groups did a serious down round in which FB was squeezed down through non-participation. Later, the portfolio company was turned around, did well and was sold for several hundred million dollars. First Boston sued and won principal and damages.

Testa Hurwitz of Boston reported a recent deal where the down round terms proposed by the preferred owners were subject to class votes and the common revolted at what were considered onerous terms and killed the deal.

The problem with these down rounds is the potential resentment, de-motivating impact, and divergence of management interests. The so-called “investors’ golden rule” says, “Those who have the gold rule”, but that rationale can also kill the goose that lays the golden eggs – motivated employees. This is a team business that requires motivation of, and participation by all. It is about long-term relationships, common goals and support in tough times. There is a limit to what money can do.

Cheryl Reicin of McDermott adds during such tough times investors’ reputations are made or lost (i.e., how do you treat folks in downtimes is more important than in glory days).

Alex Lynch of Wilson Sonsini in NYC says entrepreneurs are asking to get preferred stock options with investor level protections. This can open some tricky accounting issues, so consult your accountant firm.

At present there is little recrimination to down rounds in the courts, but after the rebound comes, watch for lawsuits from those who will say they were squeezed out unfairly. Remember that Delaware law is the friend of smaller holders and the trend of



corporate governance law is towards holding Directors to higher standards of fiduciary responsibility.

**B) Recapitalization/restructuring:**

Michael Sullivan of Cooley Godward in SF has coined the Sullivan simplification principles. In the case you have a complex equity structure with previous ABCDE rounds, they can be crunched into a new Series 1 (sharing the same investor rights), after which the next round is called Series 2. This simplifies the capital structure and minimizes conflicts between series.

**C) Price protection or anti-dilution:**

Both Cheryl Reicin of McDermott and Soren of Hale & Dorr reported that one year ago, most deals used weighted average anti-dilution provisions, whereas nearly all are full ratchet today.

In contrast, Joe Bartlett of Morrison & Foerster said his ratio 18 months was 75% weighted average and 25% with no price protection at all, whereas 6 months ago the ratio had changed to 90% weighted average and 10% full ratchet.

Most attorneys I spoke with do not generally favor full ratchet clauses. They are seen as disproportionately unfair to common shareholders and seed investors. Yet VCs are calling for full ratchet provisions ever more frequently. The lawyers argue that it is unfair to protect all prior investors versus management if there is only a small follow-on round. On the other hand, the investors say, the ratchet protection compensates for poor management execution and over-hyped forecasts that previously justified the high valuations.

Cooley Godward recommends using full ratchet clauses with a short-term (6 month) limit when the due diligence process between term sheet and contract reveals the company to be overvalued and in need of cash sooner than had been forecast by management.

**D) Pay to Play:**

Cheryl Reicin of McDermott says this type of clause is being employed more and more frequently to protect the company and management. Thus, if investors do not participate in subsequent rounds, they lose the anti-dilution protection.

**E) Warrants for Bridge Loans:**

Joe Bartlett of Morrison & Foerster says that the premium was traditionally a flat fee of 15-25% of the total or perhaps up to 5% per month warrants coverage per month.

Recently, I heard of a pair of 'top-tier' VC firms gave themselves 25% warrant coverage per month on bridge while deal was closing. Cheryl Reicin of McDermott Will & Emery



told me of a deal in which one VC is asking for 5% of the company per month. I believe that such dilution will deter future investors and kill the morale of employees.

My firm recently walked away from an investment that gave 33% warrants to the previous investors for a bridge loan averaging 3 months. We felt the premium was extreme given the modest change in the company during that time period.

#### **F) Redemption Clauses:**

This clause was traditionally meant to protect investors from the curse of the “Living Dead” portfolio companies, who choose not to aim for liquidity, but simply enjoy the lifestyle benefits of running an enterprise. In reality, it is more threat than useable weapon. Usually it begins to apply only 5 years after investment. Each subsequent financing tends to reset the redemption clock, stretching the time horizon. The clause is designed to enable investors to say, “Show me the money!” In practice, it is almost never used. Bartlett, Sullivan and Zimman hadn’t ever seen it invoked in 69 combined years of practice.

#### **G) Demand registration (pre-IPO):**

They are almost never invoked. It is almost inconceivable that VCs could force a firm go public against its will. Joe Bartlett says only rookie attorneys fight for that term. Post IPO registration rights are a different story and are valuable for VC investors who need to obtain liquidity when there is a public market for the shares.

#### **H) Liquidation Preferences:**

The general term is Participating Preferred and it was designed to protect investors against bankruptcy or low-priced trade sales. The term is also known as double dipping. The traditional standard was 1X preference, meaning first return investors principal and interest, then share profits on equal footing at 1:1 conversion into common.

As in the article about LiveMind cited previously, we are seeing demands for 4 and 5X preference ratios. The high-end numbers seem onerous and divisive. My blue ribbon panel of attorneys unanimously opposed the high multiple provisions. Historically, such provisions have almost always been cut back at a liquidity event to give more to management and employees.

Some VCs have even been requiring higher preference when converting from preferred to common shares during an IPO. Joe Bartlett calls it “supercharged preferred” and believes it should be resisted by companies.

#### **I) Preferred Dividends:**

Cumulative dividends mean the BoD never needs to declare, but they accrue and convert in-kind to benefit of investors over the years upon conversion to common. In



contrast, non-cumulative dividends lapse unless declared annually. They are rarely declared, but can serve to block the common from declaring a dividend to itself.

Michael Collins of Testa Hurwitz in Boston said that the West Coast standard is 8% non-cumulative whereas on the East Coast the standard is cumulative at 10-12%. Some attribute the difference to the fact that East Coast investors are typically more financially oriented investors.

#### **J) Staged or Milestone Financing:**

Sullivan, Reicin, and Soren were unanimous that this type of financing is regaining favor and that it can protect investors better than anti-dilution provisions. Management usually resists because it leads to uncertainty. Moreover, the pressure of large institutional limited partners has pushed VCs to deploy capital more rapidly. The major problem with milestones is that they may divide interests and overly focus management attention on peripheral goals.

#### **K) Friends and Family Shares:**

During the height of the IPO frenzy in 99/00 some VCs even began demanding directed shares prior to and upon IPO. Due to SEC problems, most clauses were written as “best efforts” endeavors. Today, there are no IPOs so the problem has subsided.

#### **L) Vesting:**

In the recent past during the bull market, companies pressured for shorter terms for employees, while investors are now pressing for longer vesting periods. Soren and Reicin report significantly more re-vesting provisions for management shares and clauses that require forfeiture unless key milestones are met.

#### **M) Up The Ladder Warrants:**

After a tough down round, Joe Bartlett emphasizes the need to re-motivate entrepreneurs and key management. When a company exceeds expectations and there is a successful liquidity event, warrants may be structured to be exercised at increasing values to reward management for the successes.

Finally, let me add among all the gloom and doom, that entrepreneurs are like artists, they create companies because they have a need to do so, and great entrepreneurs create companies that bring forth products and services of real value. Their innovations satisfy latent demand in fast growing markets. While it seems the worst of the market downturn is not yet over, in the longer term the best is yet to come. To you entrepreneurs and investors, follow your dreams, and hire a good attorney!

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