



THE INTERSECTION OF TWO PERSPECTIVES: THE LAWYER & THE VC

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For nearly 25 years, I have participated in the business of venture capital as a corporate attorney representing entrepreneurs, companies, investors and venture funds. During the past several years I have also taken on the role of a managing director of a venture fund. With this background, I have had the opportunity to view the venture industry from various perspectives over a significant period of time.

The venture industry as presently constituted is relatively young. While the world has had investors, merchant bankers and the like for hundreds of years, the venture capitalist as we understand the term today began to evolve in the 1970s. During the 1980s and 1990s the industry grew slowly and steadily, based on dollars invested, until the mid-1990s. At that point the dollars invested by venture funds began to skyrocket, creating the “bubble” we have all heard so much about and from which we are still trying to recover.

Notwithstanding this boom and bust cycle, the past 30 years have served to legitimize venture capital as a true industry where you can now decipher norms and patterns that serve as the basis for many of the day-to-day decisions made by both the venture capitalists and entrepreneurs.

THE TRANSITION TO CONSISTENCY

One of the most noticeable norms that has developed during the past 30 years is the consistency of the structure and documentation for venture capital transactions. For example, the term sheets, purchase agreements and ancillary documentation for a typical venture deal look very similar from one deal to the next. While every deal possesses unique aspects and business terms, the overall format of a typical transaction is remarkably similar. Basic terms, such as a preferred stock structure containing preferences and protections for the investor, are, in a “big picture” sense, virtually the same from deal to deal. This fact does not mean that these transactions are not complicated. But it does mean that the transactions, while being sophisticated and complicated, can be effectuated relatively efficiently. This is important to the venture process because unfortunately, for me in my attorney role, the parties do not want the legal fees and other transaction costs involved in closing a deal to be a significant part of the use of proceeds.

Another obvious norm is evidenced by the issues over which the parties will spend time negotiating. I can remember 20 years ago negotiating as diligently over the terms of a registration rights agreement as any other part of a deal. Nowadays it is rare to see the parties spend any time on such an agreement. There is pretty much a “base line” view on such an agreement, plus the knowledge that the markets and the underwriters are going to dictate what really happens in this area, so there really is no purpose in spending a great deal of time and resources on this aspect of a deal.



I believe this trend toward consistency has been helpful to the growth and development of the venture industry. It allows money to be invested more efficiently in terms of the actual transaction costs and also to set realistic expectations for the parties as to how the relationship will work – whether things go well, or things go badly.

This is not to imply that venture investing has become commoditized. Far from it. Venture investing will always be one of the most individualized transactions in existence, and it will always require an entrepreneur or management team with a unique idea or business plan that investors come to believe in sufficiently to write a check. But it also means that these types of financial transactions, like a bank loan or a car loan or a credit card purchase, should proceed more easily, readily and frequently.

REPRESENTING ENTREPRENEURS VERSUS INVESTING IN THEM

One of the more remarkable things I have learned – even if once said seems obvious – is that the entrepreneurs I want to represent are typically the ones I want to invest in and vice versa. With my legal hat on, when I am representing a startup company, I am often making an investment of my time that will likely go unpaid unless the company gets funded. You don't want to waste your time as a lawyer on a management team or a business concept that you don't believe is going to work. As a venture investor, I certainly don't want to give them money, either.

It is common to hear venture investors debate whether the management team or the business idea is more important. Some will say that it's the idea that is most important because you can always hire a different management team. Others will say that it's the people that's most important – the "I'd rather have a great management team and a mediocre idea than a mediocre management team with a great idea." I think the reality is that the best investors only invest in those transactions that have both. But, if forced to pick, I think the people are in fact the most critical ingredient. At our venture fund we have a quote hanging on the wall from Warren Buffet that bears repeating:

We intend to continue our practice of working only with people we like and admire. This policy not only maximizes our chances for good results, it also ensures us an extraordinary good time. On the other hand, working with people who cause your stomach to churn seems much like marrying for money – probably a bad idea under any circumstances, but absolute madness if you are already rich.

The other reality of early stage investing is that the business concept almost always changes as the business develops. Indeed, we have had companies become wild successes whose business at the time of our exit looks



nothing like the business plan we originally invested in. For a company to do this requires true entrepreneurs who are committed to stick with it, be flexible and opportunistic, and sometimes a little bit lucky.

While in the late 1990s it was not uncommon to see venture funds investing in true startups, in the current financing environment it is quite rare. Today the typical startup is being funded first by the entrepreneur, his or her friends and family, and maybe some angel investors. Even the early stage venture investors currently want to see a company that is up and running on some level, either close to having a developed product and preferably some revenue.

The funding of cold startups is not unheard of even now, however. Some funds, including my own, will “incubate” a company that has an interesting technology but needs to build a team to execute the plan. For example, our fund has been working with a team for more than two years that has a disruptive technology in the plastics industry. While we have invested time helping the existing team develop a plan to exploit the technology, and locating additional talent to execute the plan, we haven’t yet invested a single dollar, even though we have had an agreed-to term sheet on the table for more than a year. While we are now at the point that we actually expect to close on this investment in the next month or so, it has taken this long for us to be comfortable that we have the right people in place for the company to be successful. We signed off on the technology before we put a term sheet on the table. It demonstrates the importance of the people in this process.

And the people part of the process is a two-way street. Entrepreneurs need to find investors that they are compatible with and who they respect and admire as well. Companies that develop into an “us versus them” situation between management and the investors seldom work out. Rather, you need a collaborative dynamic between the investors and the management team in order to succeed.

When looking for investors, a company is well advised to find people that bring more than just money to the enterprise. Typically, funds are run by people with significant business experience who want to not only invest their money in a company, but also their judgment and thought. And it’s important to note that finding an investor who has previously been successful in the entrepreneur’s industry is often more valuable than the dollars they contribute.

THE INVESTMENT NEGOTIATION AND PROCESS

Valuation. Once a company and a venture fund have decided they want to do a deal together, the process follows a fairly typical path. The first issue that must be resolved is valuation. The valuation issue is driven by both internal and external factors. For example, the state of the economy and the perceived trends for the economy in general, as well as the company’s industry in particular, can figure into the debate as much as the stage at which the company is in its



development. The valuations that we are witnessing today are much lower and, in my opinion, realistic than what we saw five years ago. There is also less negotiation over this issue today, simply because it has been so difficult to raise money at any valuation. At the end of the day, the investor wants to invest at a value that it thinks protects it on the down side and offers the potential of great returns on the up side.

To the extent the parties struggle to agree on valuation, they can use different tools to find a middle ground. For example, as an investor you can agree to a higher valuation if the security you are acquiring gives you a preferential return prior to sharing in the upside with the common stockholders. This type of security, called participating preferred stock, allows the investor to get his money back first, and then share with the common stockholders in the balance.

To help illustrate this, assume I am prepared to invest \$1 million in a company for which I want to acquire a third of the company, but the company only wants to sell a quarter of its equity at that price. Assume that two years later this company is sold for \$10 million. With a straight preferred stock, my share would be either \$3.3 million if I had won the argument on valuation, or \$2.5 million if the company had won that argument. On the other hand, if I were to agree to the company's proposed valuation but had required a one times participating preferred stock, I would end up with the equivalent of what I wanted in the first place – \$1 million as a preferred return plus 25% of the remaining \$9 million equals a total return of \$3.25 million.

In the current environment the use of participating preferred is quite common. In funding rounds that represent a lower valuation than the prior round – so-called “down rounds” – you frequently see investors seeking a multiple preferred return before participating with the common stockholders. From the management team's perspective, these preferences can create a hurdle that becomes a disincentive. In these cases, the “wall of preferences” can become so high that the management team can no longer perceive an exit that will create any value for them. As a consequence, management starts to require carve outs from the preferences so that they are guaranteed to share in some portion of a liquidity event.

A note of caution: Entrepreneurs should be careful not to put forth unrealistic valuation proposals. It can bring a very quick end to discussions.

Anti-dilution protection. Another typical item of negotiation is anti-dilution protection. There are two basic types, with various options in between: full-ratchet or weighted average. A full-ratchet anti-dilution provision simply provides that if the company sells stock at a lower price in the future than that paid by the current investor, then the company agrees to, in effect, issue more shares to the investor to get his average cost per share down to the cost in the lower round. For example, if I buy stock for a dollar a share, and the company subsequently sells stock for \$0.50 a share, then the company has to effectively double the number of shares I hold for no further consideration. A weighted average



provision is a mathematical formula that has several different versions but, in each case, provides much more limited protection to the investor than a full-ratchet.

From the company's perspective, no anti-dilution protection for the investor would be the best result – but that simply doesn't happen when the investor is a professional venture fund as opposed to, perhaps, an angel investor. The next choice would obviously be a weighted average provision. From the investor's standpoint, this issue is driven by its perceived risk in properly valuing the company. If the premoney valuation is low enough, the investor is more willing to live with a weighted average provision. Another middle ground is for the investor to initially require a full-ratchet provision but agree that either by virtue of the passage of time or the occurrence of another round of funding at a sufficiently higher valuation will cause the full-ratchet to revert to a weighted average provision. The thinking here is that the need for a full-ratchet should diminish over time based on the performance of the company or its ability to attract additional funding at a higher valuation.

Board of Directors. Finally, another item of discussion is how the parties should populate the board of directors. Professional investors typically require a seat on the board. In our fund it is very rare for us not to do so. Founders are often worried about losing control of their enterprise to the investors. The fact is, venture investors are not typically interested in control unless things are going badly and they feel they need to step in and protect their investment. The agreements usually define the events that would allow the investors to do just that. But in the normal situation, the investors are viewing the board arrangements as simply how the parties are going to work together.

Board composition from their perspective should be based on which participants can bring the most value to the company. That often results in a mix of founders, investors and outsiders with some special industry expertise that would benefit the company. In fact, founders who are adamant about retaining board control send up a red flag to a venture investor. It starts to set up the "us versus them" dynamic discussed above. Like putting forth an unrealistic valuation, the improper handling of this issue can cause an investor to lose interest in the founder's enterprise.

Another concern raised by a founder's adamant desire to keep control is whether the investor is being asked to fund what I call a "life-style" business. A founder who views it as more important to call all the shots than to accomplish what the larger group may think is the best course of action for the company is antithetical to a venture investor. The entire construct for venture funds is that the company and the investors, working as a team and marshalling their collective resources, can accomplish a much better result than a founder who feels he or she has to be the deciding voice on every decision.



MERGERS AND ACQUISITIONS OF VENTURE-BACKED COMPANIES

The ultimate result that every venture fund seeks for every investment is a positive liquidity event. There are basically two alternatives: a public offering (the infamous IPO), that serves to create a market that the investor can sell his shares into either as part of the offering or over time, or a sale of the business. In the current environment, sales of businesses have been much more common than public offerings.

The process for an M&A transaction is similar to that of a venture financing. First, there is a term sheet or letter of intent where the basic business deal is agreed to subject to numerous conditions and caveats. And of course, like a venture deal, the first big issue is valuation or price. When the parties have difficulty agreeing on price someone usually suggests an earn-out scenario. With an earn out, the parties leave some or all of the ultimate purchase price to be determined by the company's future performance.

Earn outs are fraught with peril for the seller and require a great deal of thought and negotiation. First, you typically are no longer in control of the company going forward, and that fact becomes a risk to maximizing the potential earn out price. Second, a formula based on anything other than gross revenues quickly becomes subject to endless imponderables that can affect the result. From a buyer's perspective, however, an earn out is a "no lose" situation. If the company performs, then you should be happy to pay the price. If it doesn't perform, then you don't find yourself in the position where you have overpaid for a company. It certainly puts a buyer in a position where it can agree to pay more than it otherwise would.

When selling a portfolio company, a venture fund is typically focused on merely getting the best price. There are two parts to price: getting the money and then keeping the money. In other words, it is important not only to get the buyer to agree to pay the highest possible price, but also to structure the deal so that you believe you won't have to give money back to the buyer as a result of indemnification claims or other allocations of risk – whether known or unknown.

For the management team and founders, there are typically more issues than price with which to be concerned. In the normal acquisition, one of the assets the buyer wants is the people. Thus, in addition to their share of the purchase price, the management team and founders are concerned with the terms of their relationship with the buyer going forward and how they will be compensated.

The typical M&A contract is divided into several parts. Part One outlines the basic business deal – who is selling what, for how much, payable when and corporate structural issues. Part Two consists of representations and warranties – usually quite extensive – about the status of the business and its assets. This part of the agreement has attached to it disclosure schedules, and lists all the exceptions to the representations. The normal deal provides that if the buyer



was made aware of something by its inclusion in the disclosure schedules, then the buyer acquires the company subject to that matter and it is the buyer's problem. Sometimes, however, even though a matter is disclosed, the buyer wants the seller to continue to be at risk for that matter. For example, when a business is confronted with a known environmental problem whose cleanup costs cannot be accurately quantified, then a buyer may want the seller to continue to bear some or all of those costs.

Part Three of the agreement contains the representations and warranties of the buyer. In an all cash deal, these tend to be minimal. If the transaction is a stock swap, then the seller has as much interest in knowing about the status of the buyer as the buyer does the seller.

Part Four of the agreement typically contains the respective covenants of the parties concerning things they each will or won't do, whether before the closing or after. There are also usually set forth the various conditions to each party's performance of the agreement.

Part Five is the indemnification obligations of the agreement. This section sets forth who is indemnifying whom, for what, for how much, and for how long. Needless to say, this section attracts the attention of the parties and is a focus of the negotiations. These provisions ultimately determine how much of the price the seller gets to keep.

The indemnity provisions often provide for so-called baskets and caps. Baskets, typically set at an amount that represents some small portion of the price, say one percent, are used to deal with the typical "nickel and dime" issues that are discovered by the buyer after the closing. Once the basket amount is exceeded, then the seller may agree to pay the basket amount plus the losses realized in excess of that, or the buyer may agree to pay the basket amount and hold the seller responsible only for the excess.

The cap addresses what the ultimate exposure of the seller will be. It can be the entire purchase price or something less than that – in larger deals 10% to 30% of the purchase price is not uncommon. It is also common for the cap to be the entire purchase price for certain reps and warranties (such as title to stock, corporate existence and authorization) and something less for things like inventory, litigation, etc.

Finally, there is the issue of the duration of the indemnity obligation. Again, you usually end up with different time periods for different representations. For example, the obligation to indemnify for whether the seller has good title to the stock it is selling can go forever, taxes can be for three years from the filing of the last return and other matters could be for a year or the completion of the buyer's next regularly scheduled audit.



THE VENTURE CAPITAL BET

A venture capitalist is taking a risk with every investment it makes. It is akin to gambling and each investment is a bet. You are betting on technologies that are not necessarily proven and on management teams. Even with extensive research and due diligence, the risks of the unforeseen and the unknown permeate every transaction. And one quickly learns that in the world of venture investment, most surprises are bad.

Process and procedure can help reduce risk. Having a due diligence routine for every deal helps identify the risks associated with each particular deal. Playing only in industries where you have a knowledge base within the principals of your fund also helps mitigate risk. Finally, having certain in-house rules also can protect you. For example, in our fund, while we typically like to lead the deals, we always require that there be a least one institutional co-investor. We have found our results are much more consistent when we honor this rule than when we do not.

There are two primary benefits to this rule. First, we have the benefit of another fund running a deal through its own process, which is inevitably different than ours. It allows us to compare notes where each fund learns something from the other that they did not discover from its own process. It also allows the funds to really focus on those things where they have arrived at the same conclusion, whether it is a risk inherent in the deal or an opportunity the company can take advantage of. Second, and equally important, it means you should have a built-in partner to provide the company with additional funds whether because things have gone better – or worse– than expected.

FUTURE TRENDS

From the legal aspect, I believe there will continue to be a trend toward consistency in the way venture transactions are documented. The parties want transaction costs to be minimized. The one area where this is still very much a challenge is in the down-round scenario. Every down round is unique and complex. They are the investments that for whatever reason have not gone well or as expected or hoped. They typically require a complete restating of the various parties' rights, which always entails working through complex issues and multiple-party negotiations. As a result, the transaction costs are always higher than desired, even when the parties are all in fundamental agreement.

From the venture side you must start with the understanding that it is a cyclical industry like any other industry. The bubble that we have gone through was historically extreme. The amount of value that evaporated is of devastating proportions and, frankly, I do not believe that it has yet to be fully acknowledged and accounted for on the venture funds' books. The number of venture funds operating has been decimated. All of these reasons make this an excellent time for those venture funds that have cash to invest. Company valuations are back to sensible, if not downright



attractive, levels. As a result, the investments being made today by venture funds hold great promise. As that promise is realized it will become easier for the funds to raise new pools of capital and the cycle will begin again. And of course, this time, I am sure no one will get crazy again like they did in the bubble! (Yeah, right.)

OBTAINING THE BEST RESULTS

In summary, what does this boil down to for both investors and entrepreneurs if the goal is to obtain the best results? First, it is all about the people, on both sides of the investment ledger, and their ability to work together as a team. Second, venture capitalists should stick to those industries and spaces where they have some core knowledge that allows them to bring more to the table than just money. From the company's side, they should be looking for the same thing. While all money may be created equal, it has more value to a particular company depending on where it comes from and, as a result, what additional benefits for the company come with it. Finally, entrepreneurs should embrace today's more logical valuations. It makes it much more likely that the right deals will attract the appropriate amount of funding and that the overall results for the investors, as well as the founders and management team, will be better.



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Mr. Penman has spent his entire legal career at Brown Rudnick Berlack Israels LLP, an international law firm of 200 attorneys. He is a member of the firm's Management Committee and Chair of the firm's Corporate & Securities Department.

Mr. Penman represents public and private corporations in a wide array of corporate transactions. He has extensive experience representing companies and investors in venture capital and private equity transactions, in addition to representing issuers in public offerings of their securities. He assists foreign and domestic clients in connection with the acquisition and disposition of public and private targets in transactions valued up to \$1 billion. His practice also includes assisting clients in structuring numerous types of acquisitions including auctions, LBOs, acquisitions and dispositions of product lines, divisions and businesses, cross-border transactions, earnouts, tax-free deals, and forward and reverse triangular mergers.

In addition to his leadership role at Brown Rudnick, Mr. Penman is a Managing Director of the Venture Capital Fund of New England (a SBIC Venture Fund).

Mr. Penman earned his law degree from the University of Virginia and holds a Bachelor of Arts degree from the College of William and Mary.