Virginia Business Lawyers

Point Number 8 on How To Pursue Venture Capital

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Know your financial structure. In our last post, we covered a number of factors that affect the founder's ultimate ownership percentage. In this section, we have a bit more detail. What you need to know up front that the venture capital investment process has become highly standardized. In many ways this is a good thing. It helps both parties know exactly where they are in a deal. Many founders, however, may find themselves uncomfortable with some of the fairly typical deal terms.

If you're serious about raising venture capital, you must be prepared to accept virtually all of these terms, if you expect to close. In the process, it's crucial that you be honest with yourself. If you really cannot get comfortable with the standard terms, you would be better off bootstrapping your company. Otherwise, talking to VCs — let alone getting into extended negotiations with them over terms that are pretty much nonnegotiable — is a waste of your time and theirs.

So here are some of the biggies.

1. The stock you own may be "reverse vested." What does this mean? It means that even though you issued stock to yourself when you formed your company (or LLC membership interests, as the case may be), the deal terms may require you to put substantial amounts of your equity at risk. This is the VCs way of making sure you stick around. In effect, you have to earn your equity back. The period over which you earn, the equity back may be from 3 to 5 years, and it may affect all or maybe just a portion of the equity. But you can pretty much count on subjecting a significant portion of your ownership to this mechanism.

2. The VCs will not buy common stock or its LLC membership equivalent. They will have what is known as a liquidation preference. Simply put, they get their money back before you get any of yours. When venture money is especially scarce, or IPO conditions are unfavorable, the VCs may even ask for a multiple liquidation preference. This is a way of extracting a decent return even if the company's performance is mediocre.

3. You will sign an employment agreement that will enable the VCs to fire you if you're not performing. There is significant flexibility in terms of compensation, perks, etc. But the bottom line is, if you're not

getting the job done, the VCs can and will replace you. The employment agreement may grant you termination benefits, which can be either generous or downright stingy. These are some of the areas where you can negotiate successfully, as long as you stay within the framework.

4. The VCs will have the right to participate in any public offering of stock. They will also have the right, under certain conditions to demand that you register their stock for sale with the Securities Exchange Commission, even in the absence of an IPO. At the same time, you may have to agree not to sell your stock in the IPO and for some time thereafter. Investors generally think it's a bad thing to see founders cash out at the IPO. This demonstrates a certain lack of confidence in the company's future, and of course the price of the IPO is based almost entirely on the company's future. So even though you will look wealthy on paper the day after the IPO, you may be no more liquid than the day before.

5. VCs do not have infinite patience. They have to answer to their investors, and they expect to invest and recover their funds over period of 5 to 10 years, but the sooner the better. That is why they require redemption rights. Redemption rights allow them to turn in their stock for a return of the original capital plus all accrued dividends. This protects the VCs in case the company makes progress, but is not able to arrange an IPO or acquisition, whether due to market circumstances or less than stellar company performance. By maintaining the right to get their money back, the VCs can have greater assurance that they can close out a fund, clearing the decks for them to raise another. Bear in mind, the VC's job depends entirely on their ability to both invest and recover capital within a reasonable timeframe. Most of their investors are institutional (insurance companies, pension funds, sovereign wealth funds, etc.) and all of them desire some degree of predictability.

These are just a few key points that often pose problems for founders. Founders tend to be self-reliant, control oriented, highly confident (sometimes to a fault) and utterly convinced that they have the right idea, and the unique ability to bring it to fruition. These same factors that make entrepreneurs successful can also get in their way in the venture capital process. As a founder, you have to realize that the VCs assume that you possess all of those attributes, otherwise they probably wouldn't even be talking to you. But from their experience, they know that they have to control founders for their mutual benefit. The faster a company grows, the sooner it outgrows the management capabilities of the founders, requiring installation of "professional" management. The mentality of the professional managers can be quite at odds with the entrepreneurial mindset, and clashes are the rule rather than the exception, so be prepared.

For a complete overview of the terms of venture capital deals, look at the NVCA model documents. By downloading these documents, you can at least be forewarned, and forearmed before entering into negotiations. It's no secret that these terms can be tough. But at least you can anticipate them and make your decisions accordingly.