



GUEST ARTICLE

TIME TO REBOOT THE BASIC VC DEAL STRUCTURE



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New York Times columnist **Tom Friedman** recently suggested that “It’s Time to Reboot America,” meaning that the financial crisis gives us a chance to fundamentally re-examine the way government and the private sector operate. Perhaps it is also time to re-examine the basic venture capital deal structure that has changed little since the 1970s.

A related issue is bloated legal documents. Simple forms that address only realistic scenarios are desirable. Sensible legal documents do not have to paper to death every one-in-a-thousand scenario. Simple, common-sense documents are easier for all parties to understand and be comfortable with, and they are cheaper and quicker to negotiate and sign. This approach may be a competitive advantage, or if broadly accepted, would promote a better outcome for all parties.

Where do we start?

Registration Rights. The reality of how an IPO works in practice is that the issuer’s registration rights agreement is never taken out of the drawer—other than to find the waiver provisions. Forget demand rights to force an IPO. It never happens and is intimidating to entrepreneurs.

Forget piggy-back rights other than in connection with an IPO; the secondary/follow-on offering process for public companies has become so streamlined that the delay that would be needed to implement

piggy-back registration provisions could jeopardize a potential offering that is in everyone’s interest.

Demand rights after the IPO are obsolete. For one thing, SEC rules relating to resales have been relaxed. Also, the market reality is that secondary offering exits happen only when market conditions make them feasible. When they are feasible, it is in everyone’s interest to eliminate the overhang of the VCs’ shares and register them for resale.

If it is in everyone’s interest, you don’t need an agreement. Instead of demand rights, investors should consider doing what PIPE investors have been doing for years: providing for automatic, not demand, shelf registration rights for affiliates to permit unrestricted resales after the IPO lock-up period.

What’s left of the standard registration rights boilerplate? It’s probably just indemnification. That could be a simple covenant in the investors’ rights agreement to the effect that the investors are entitled to indemnification for ‘33 Act liability on a resale registration.

Price Anti-Dilution Provisions. It is hard to see how these provisions benefit anyone. Let’s first start with fairness. Why should investors be price-protected on the downside? That’s the bet they make. If there are new economics at play in a subsequent round, the pricing of that round by the participating investors will take into account the existence or lack of price anti-dilution. Investors that don’t participate, along with management, will all be diluted on the same basis.

Representations and Warranties. For a Series A round, 10 to 15 pages of representations and warranties are not necessary. The business and legal affairs of the company at that stage are likely very simple. In a Series B round, the existing investors know enough about the company that they shouldn't need extensive representations. New investors could well make do with less than overly complex representations.

If long or short representations are breached, what is the investors' remedy? The irony is that if they sue the company, they are, in effect, suing themselves for their own money and paying the other side's legal expenses. If they are looking for rescission, it will take years to get their money back, and since the company would not fundable because of the lawsuit, at the end of the process there likely will not be anything left.

What's the alternative? In the Series A round, some basic company representations, plus some simple, fair and non-threatening representations from the founders—like no actual knowledge of IP problems and no undisclosed promises of equity. Most of the “real” representations in later rounds are largely covered by the required legal opinion in any event.

Right of First Refusal/Co-Sale. Why should the founders ever be permitted to sell shares prior to a liquidity event? They almost never do, anyway. This concept could be effectively implemented by a simple provision that says that any sale by a founder would require the consent of the investors. One of the conditions to granting permission could be offering a co-sale right to the investors.

Redemption Provisions. These provisions actually were omitted in the Internet heyday. They don't work and are almost never used—companies never have the money to pay up. If the company had the money to pay up, the investors likely would not be disgruntled and want out, or the company would be happy to buy them out.

If this provision actually had teeth, like the rare provision that changes the board composition, under any but the most extraordinary circumstances, it would be entirely unfair to founders to require ceding board control without the effective ability to pay up in the first place.

Dividends. Some agreements provide that the company will pay dividends on the preferred as a priority “if declared by the board.” What board would vote to declare a dividend

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on the preferred and not the common? Why not simply provide that no dividends can be paid at all without all constituencies agreeing to it?

Liquidation Preference. This is one area where investors shortchange themselves. Why should the founders get any money out of the deal unless the investors earn an equity rate of return? There should be a minimum IRR recovery as part of the liquidation preference in lieu of an accruing dividend. Participating preferred has always been a thorn in the side of entrepreneurs. If the investor were entitled to a priority equity return, a participating preferred feature would not be necessary.

Employee Pool. The concept of the employee pool never made corporate finance sense. Why not offer the company a “true” pre-money valuation, and price the round by dividing that valuation by shares outstanding and vested shares under option? Unvested options are earned after the investment and are essentially in lieu of other compensation.

Why should the founders pay for that compensation and not the investors? The pool is a fiction. When the pool is exhausted, it always is simply increased. You need to give equity incentives to employees to grow the business. They are the ones who create the value.

Down Rounds/Founder Anti-Dilution Protection. The abusive down round has tarnished the industry. Try explaining to a founder why the investors hate him/her at a \$1 per share when only recently they loved

him/her at \$10 per share. The standard rationale is “market conditions.”

The only problem with that rationale is that there is no market. VCs don't do hostile takeovers/investments. The standard “protective” procedure is to have an outside investor “price” the round. But how does an outside investor proposing an unfairly low valuation protect the existing investors when they make the same unfair investment?

A solution to this problem is difficult precisely because of the lack of a real market. I have proposed one solution—a specified minimum share of the ultimate liquidity proceeds for founders that would vest like equity compensation (*see my column on this topic in the October 2008 VCJ*). Many down rounds could be challenged under Delaware case law imposing an “entire fairness” standard on insider transactions. That doctrine permits a hindsight assessment of the procedures and price. A protective provision that should be considered would be to cut the pre-down round stockholders in on an unexpected and near-term big win.

The Alternative

An alternative deal structure would greatly simplify the standard **National Venture Capital Association** documentation to look like this:

- Stock purchase agreement with basic company representations and some basic, reasonable and knowledge-qualified founder representations on things they should know about.
- Investors rights agreement with IPO piggy-back and shelf registration rights only, basic indemnification provisions and basic reporting and other covenants.
- No ROFR/Co-Sale agreement—founders are restricted from selling their shares until a liquidity event.
- Charter amendment, with a specified IRR as the liquidation preference, no participating preferred, a prohibition on dividends, no price anti-dilution protection and no redemption provisions.

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