

What Are the Terms? Part 2 Investors Need Some Control After Their Checks Are Cashed

This is a Reprint from the Monthly Column in **Boston Business Journal**

STARTING UP: *Practical Advice for Entrepreneurs*

By: Joe Hadzima



Joseph G. Hadzima, Jr.
Senior Lecturer, MIT Sloan School of Management
Chair, MIT Enterprise Forum, Inc.
Managing Director, Main Street Partners LLC

jgh@mit.edu
jgh@alum.mit.edu

What Are the Terms? Part 2 - Investors Need Some Control After Their Checks Are Cashed

This is the second installment of our look at the "non-price" terms of a typical professional venture capital termsheet. In last month's column I suggested that entrepreneurs and investors think about four broad categories of investment terms in order to keep the big picture in focus as they try to fathom the complexities of the deal. These categories are: (1) A Preferred Return, (2) Protection of Valuation and Position re Future Money, (3) Management of the Investment and (4) Exit Strategies. Today we will explore the second and third of these categories.

Protection of Valuation and Position re Future Money. This second category of terms is designed to protect the investor from having overpriced the original deal and to assure that the investor has a say in future financings.

Antidilution. Antidilution adjustments, which we discussed in some detail in an earlier column, increase the amount of stock received by an investor if the company issues additional stock at prices which are lower than that paid by the investor. Because there is no readily ascertainable independent market price for the stock, investors believe that they should be protected against having overpaid. Another rationale is that the entrepreneur should pay if he does not increase the value of the company by the next round of financing. However, from the entrepreneur's side a decrease in the value of the company could result from events beyond the entrepreneur's control- e.g. a stock market crash or a change in the law. Having said this, antidilution adjustments are almost always present in one form or another.

Approval Rights. Separate approvals of the investors are usually required for any new financings and there is most often some form of pre-emptive rights, meaning that the investors are given the first opportunity to participate in the next round of financing. Pre-emptive rights should be particularly important to early stage investors whose seed capital launches the venture. You can think of pre-emptive rights as buying a ticket to the main show if the seed capital preview looks promising. In theory the separate approval right coupled with antidilution protection and pre-emptive rights can create interesting dynamics in which the investors only approve a deal in which anti-dilution protection kicks in, thereby increasing their ownership. However, I have not seen this happen in the real world unless something has gone terribly wrong with the business.

The past few years have seen the introduction of "pay to play" provisions for this category of investment terms. The idea is that anti-dilution adjustments and pre-emptive rights should

not be available on a going forward basis if the investor does not step up to the plate and put in his share of the money in the next financing round.

Because of this category of terms, the entrepreneur needs to understand clearly that it will be difficult, if not impossible, to get rid of the investor. Morale: (a) make sure you check out the investor's track record and (b) get comfortable that you can establish a good personal working relationship with the investor.

Management of the Investment. The third general category of terms provides the investor with a say in the management of the venture. When confronted with these terms many entrepreneurs find it hard to accept the fact that most investors do not want to manage the company. Although some private investors really do want to get involved with the company, most investors only want to make money. They do this by trying to invest in good business concepts run by good management teams. I have yet to see an investor who consciously says that he is investing in the business concept even though he has serious doubts about the management team.

So why does an investor need certain management rights? First, once the investor's check has cleared the company's bank the investor has done everything he promised. As a result, the investor needs some way to step in if the entrepreneur doesn't perform his side of the deal. Second, many "investors" are not investing their own money, they are playing with money entrusted to them by pension funds, insurance companies, educational endowments and wealthy individuals. When other people's money is involved the law imposes fiduciary duties to oversee and monitor the investment in a prudent manner.

What terms are in this category? The investors usually get one or more seats on the Board of Directors or they have "visitation rights" to attend Board meetings and to meet with management on a periodic basis. They also receive information- monthly operating reports, quarterly unaudited and audited financial statements. Separate approval of the investor Directors may be required for such items as major capital expenditures, borrowing from banks or deviations from previously approved business plans.

As a form of indirect management, Investors often establish some "carrots and sticks" to keep management focused. Vesting of the stock of key management provides a penalty if managers leave the business. Employment agreements including non-competition covenants also help keep the entrepreneur focused. Stock transfer restrictions and co-sale/take along rights prevent management from bailing out or trying to cash-in on its stock position prematurely. Stock option pools enable management to bring in additional personnel to help growth the business and can provide additional incentives to senior managers.

Aimed with an understanding of these two categories of investment terms, the entrepreneur may be able to negotiate variations on these terms which address the investor's underlying concerns without unduly constraining the entrepreneur.

Next time: Exit Strategies and the Harvesting of the Investment-why it is important to plan for success.

DISCLAIMER: This column is designed to give the reader an overview of a topic and is not intended to constitute legal advice as to any particular fact situation. In addition, laws and their interpretations change over time and the contents of this column may not reflect these changes. The reader is advised to consult competent legal counsel as to his or her particular situation.