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Full Ratchet™

News and Views for Emerging Growth Companies and Venture Capital Investors

Tainted Love

"Once I ran to you, now I run from you…."

The downturn in the public equity markets for technology stocks has led to dramatic reductions in valuations of early stage technology companies, as any entrepreneur currently seeking venture capital financing will confirm. Gone are the days when a promising start-up had several eager venture VCs clamouring to invest. For those start-ups that are fortunate enough to have profitable business models, earnings visibility or other currently suitable characteristics for venture capital investment, negotiations with prospective investors tend to be more protracted and are not as entrepreneur-friendly as they were several years ago.

The venture capital term sheet, which summarises the principal financial and other terms of a proposed investment, is a bellwether of VC investing. How has the economic downturn affected the venture capital term sheet? A review of VC term sheets between approximately 1998 and the present shows three distinct phases in investor philosophy regarding appropriate terms and protections for a VC investment. This article summarises the changes that have occurred in this critical time in the history of VC investing and speculates as to what the future holds for the VC term sheet.

Late 1990s: The Golden Years

It is important to remember exactly how different the venture capital industry was in the late 1990s and the reasons why investors were not as focused on many of the deal terms that receive so much attention today. At the height of the boom of the "new economy", an unprecedented fever pitch surrounded VC investing. Karim Abouzahr, Director at Softbank Europe Ventures, describes term sheets during this period as "Love Letter" term sheets. "Getting money into the company as soon as possible was the name of the game," says Abouzahr. "As a result, certain investor protections were overlooked or ignored." Abouzahr recalls that as late as 2000, it was not uncommon to see VC investments structured with 1x liquidation preferences and no redemption rights or anti-dilution protection.

While some of this disregard for investor protection can be attributed to a carefree attitude toward investing or the increased bargaining power of the startup, Abouzahr explains that there is some logic to the lackadaisical attitude that investors had toward deal terms that otherwise serve to protect their interests: "You had an unprecedented number of start-ups eager to fill a defined space. The biggest priority was to fund the companies that you thought would succeed so that they could ramp up and begin to execute on their business plan. Redemption provisions, liquidation preferences and antidilution protection, while perhaps there, were simply not the focus. If some of these companies were forced into a liquidation or downround scenario, your investment was probably lost anyway."

Early 2000: The Bottom Falls Out

In early 2000, the landscape for venture capital investments began to change in a dramatic way. As public markets wound down, making investment exits through initial public offerings less viable, a wave of uncertainty passed over the VC investing community. With a number of newly funded (but far from profitable) companies in a pipeline to the public markets that was rapidly drying up, the balance of power

between VCs and start-ups shifted in favour of the VCs. As one would expect, the increase in bargaining power of VCs resulted in investment terms that were markedly more VC-favourable.

"The pendulum swung hard - too hard - in the other direction," says Abouzahr. In every way possible, VCs began to demand more from the companies that they invested in. George Powlick, Managing Director at Doughty Hanson Technology Ventures, explains that the onerous terms were dished out to start-ups regardless of investment risk. "Many VCs imposed harsh terms simply because they could," says Powlick. In Abouzahr's opinion, the days of the "Revenge Letter" term sheet had begun.

One of the significant changes was an increase in the level of anti-dilution protection for the VC investment (see the second box on this page). In the "golden years," weighted average anti-dilution protection was the standard, and "full ratchet" protection was rare, typically available only when the start-up failed to achieve certain milestones or comply with certain covenants. In certain limited instances, a start-up with several financing options might even have been able to negotiate no price protection for investors. Beginning in 2000, full ratchet protection became a common element of the Revenge Letter term sheet.

Other notable changes appearing in the Revenge Letter days were:

- funds invested in multiple tranches where investors are obliged to fund only if the start-up satisfies various revenue or other business-related milestones (sometimes referred to as "tranching");
- as a 2x, 4x (or even 8x or 12x) liquidation preference;
- a return of redemption rights;
- a "drag-along" right enabling the VC investor to force all shareholders to consent to the sale of the company to a third party; and ?
- a "forced sale" or "forced exit" provision enabling the investor to force the board to sell the company in the event the company does not go public before a specified period of time.

The Present: Moderation?

In recent months, as the economic downturn appears to be bottoming out, the extreme Revenge Letter term sheets of 2000 and 2001 are being replaced with term sheets which provide for a more moderate level of terms and protections for a VC investment. Happily for entrepreneurs, some of the more outrageous terms imposed in 2000 and 2001, such as an 8x or even 10x liquidation preference, seem to have been aberrations.

While these more moderate term sheets may signal a partial re-adjustment of bargaining power between the entrepreneurs and the VCs, they may also be the result of a re-evaluation by VCs as to what they should be asking for. In fact, some VCs may have shunned the Revenge Letter approach in the first place. George Powlick, for example, is not a fan of the Revenge Letter approach: "Our philosophical approach to investing is that it should be based on fair valuations and reasonable terms. A Revenge Letter approach can be very detrimental to a start-up, and can also in the end be self-defeating for the investor. We never attempt to make up for an unrealistically high valuation by imposing onerous investor protections." Karim Abouzahr agrees that harsh term sheets may prove counter-productive to the investor's goals and may wreak havoc on management incentives: "Providing an effective management incentive structure becomes more crucial, not less, in times of economic instability, and imposing huge liquidation preferences or draconian ratchet protection, which may result in substantial dilution to management, kills these incentives. Winning the term sheet fight for the sake of winning is not important."

Powlick also points out that the mix of rights and protections granted to an investor in the first round will almost always be the starting point for negotiations with an investor in the next round. Thus, for the start-up, agreeing to an onerous first round will likely come back to haunt the start-up in subsequent rounds. For the investor who negotiates a great deal in an early round may find itself being forced to give up those hard-won rights to subsequent investors in order for the portfolio company to obtain future funding. As Abouzahr points out, the first round investors will often be negotiating side by side with management in subsequent rounds or trade sales, and it is useful to keep this in mind when striking the appropriate deal for the first round financing.

The Future for VC Term Sheets

So what does the future hold for the terms in venture capital transactions? While it is impossible to predict with certainty, it appears that at least a few terms that became more prevalent in the Revenge Letter days may be here to stay, albeit in a more moderate fashion.

For example, some investors feel that tranching can continue to be an effective way for an investor to manage the risk of investing, even after the economy strengthens. "We have found that tranching can be an appropriate method to control a company's cash burn, as long as it is applied in an intelligent manner," says Abouzahr. Not all VCs, however, are supporters of tranching. Powlick believes there are inherent difficulties in setting milestones because the ever-increasing and fast-paced rate of technological change can end up creating the wrong incentives.

Redemption provisions might also receive a bit more attention. Because VC investors typically utilise close-end investment structures that require them to realise returns on their investments over a limited duration, they must evaluate the various exit strategies available to a company in connection with their investment. Due to the continued sluggishness of the public equity markets, the projected length of time from the seed stage to the IPO stage is significantly longer today than it was in the late 1990s. Even though a company may find itself operating in the black, it may never be viewed as a suitable candidate for going public or being acquired. Due to the reduced frequency of these more traditional exit routes, the right to cause the company to redeem shares will become more important to investors.

The terms of VC investments will be shaped by what the market delivers in the months and years ahead. If anything, the past several years have taught us that factors such as market confidence (and over-confidence), market timing and momentum can vastly alter the way VC investments are structured. It is likely that similar factors will continue to shape VC investments well into the future.

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Route 128 Update

Pay-to-Play Provisions: Traps for the Unwary

Pay-to-play provisions are designed to encourage a company's existing investors to provide additional capital to the company, particularly in a down round financing. While pay-to-play provisions (which might be more aptly named "play or pay" provisions) are becoming increasingly prevalent, they can have unintended consequences if not thought through properly. The following highlights a number of issues that should be addressed when instituting pay-to-play provisions:

How they Work: With pay-to-play provisions, everyone pays, one way or another. If existing investors subject to pay-to-play provisions do not purchase their pro-rata portion of the down-round securities (or "play" in the down-round), the price they "pay" will be to lose some of their existing rights. Typically, the

non-player's existing preferred shares are converted into a new class of preferred shares. The new class is usually identical to the existing class of preferred shares except it may not have:

- price anti-dilution protection, or it may have less favourable price anti-dilution protection (such as weighted average price anti-dilution protection instead of full ratchet protection),
- voting rights,
- a liquidation preference, or ?
- some combination of the foregoing.

In more extreme cases, the non-player's existing preferred shares are converted into ordinary shares, thereby losing all of the advantages of the preferred class.

Beware of Unintended Veto Rights. Certain actions, such as the sale or liquidation of the company or the authorisation of additional securities, often require the approval of a specific percentage of the voting power of the existing class. If overlooked, there is an unintended effect of creating a class of preferred shares, held only by the non-players, with separate class voting rights (i.e., veto rights for those same actions). To prevent this outcome, ensure that that the existing class and the new class will vote together as a single class on all matters (except as otherwise required by law).

Review Investor Contracts Carefully. Other investor rights and obligations, such as rights of first refusal/co-sale and voting rights and obligations, are usually set forth in agreements among the company, founders and other investors. Each of these contractual provisions should be carefully reviewed to make certain that they anticipate the possibility that the existing class may convert into a new class without unintentionally divesting the holders of rights or freeing them from obligations upon conversion. Also consider how the creation of a new class will affect the waiver and amendment provisions of investor agreements. If it is intended that the rights and obligations of the holders of the existing class and the new class are to be the same, then one needs to make it clear that the existing class and the new class will vote as a single class on all amendments and waivers.

"Pro-Rata" Calculations. As a result of changing market conditions, it is frequently the case that a company's earlier class of preferred shares will not include pay-to-play provisions but that such a provision will be included in later rounds (meaning that only the class of preferred shares issued in the later round will be forced to convert into a new class if the holder does not participate pro-rata in a subsequent financing). This leads to the issue of whether an investor's "pro-rata" portion of the future down-round financing should be calculated based on its total ownership of all classes of preferred shares of the company or only its ownership of the class containing the pay-to-play provision. While there is not a correct answer, some investors view the inclusion of a prior preferred class, without a pay-to-play provision, in the calculation as unfair, since it effectively imposes pay-to-play obligations on the prior series.

Be Aware of Dissenters' Appraisal Rights. In some jurisdictions, an amendment to implement pay-to-play provisions retroactively will entitle dissenting preferred shareholders to have their shares repurchased by the company at their appraised fair value.

Richard Kimball

Silicon Valley Update

Silicon Valley Venture Deals: 2001 vs. 2002

Raising venture capital in Silicon Valley has changed significantly over the last two years. Silicon Valley deal terms have evolved from an old standard to what is now becoming the new standard for venture capital financings. The following are several key terms in Silicon Valley venture capital investments that have changed significantly:

Liquidation Preferences

2001: 1x purchase price plus participation rights up to a cap
2002: 3x purchase price plus participation rights and no cap

Potential pitfalls: Liquidation preferences which grant new investors guaranteed amounts before current investors and founders see any return and then continue to participate without a cap limit downside risk for the new investors in the event of a merger, reorganisation or dissolution of the funded company. However, such preferences also dis-incentivise (1) new investors to convert their preferred stock and (2) existing investors to agree to sell the company except at a very high valuation. If a company's strategy is to merge or be acquired, these factors can create problems when a company wants to effect such a transaction.

Anti-dilution Protection

2001: Broad-based weighted average
2002: Full ratchet for a year and broad-based weighted average thereafter

Potential pitfalls: Anti-dilution provisions grant investors price-based protection in the event of a subsequent stock sales at prices below their purchase price. With full ratchet, issuance of below issue price securities must be entirely avoided in order to avoid triggering an adjustment. Carve-outs to the adjustment should be carefully negotiated so that adjustment is not accidentally triggered where such adjustments would not normally be warranted. In addition, full ratchet adjustments can create a disincentive for subsequent investors since any additional funding could adjust voting power in an adverse manner to such new subsequent investors.

Drag-Along Rights

2001: Very rare
2002: Right to force common and preferred stockholders to sell company upon majority of preferred approval

Potential pitfalls: Granting drag along rights can give investors too much power to effect the transaction of their choice. In particular, with liquidation preferences which can effectively make it make sense for the most recent investors to want to sell the company for valuations which benefit themselves but no one else, the investors may be at odds with the desires of the common stockholders. If the most recent investors have the board representation to effect a sale, the remaining stockholders will have no choice but to vote for a transaction from which they may not stand to benefit significantly. Sometimes drag-along rights may be requested by new investors for future financings above certain dollar amounts and/or above a valuation threshold, which can also be detrimental to prior investors of the company for the same reasons.

Protective Provisions

2001: Investor approval of senior and pari passu securities, sale of company, change in rights of preferred, increasing or decreasing the size of the board, amendment of charter or bylaws
2002: Investor approval of above plus incurrence of debt over certain amounts, acquisitions of other companies, making expenditures, engage in a different business, approval of budget plans, changes in compensation of executive officers, dissolve or wind up the company, license any of the intellectual property of the company, enter into any loans for the benefit of the company or any executive officers or employees of the company, pledge a security interest in the company, approve contracts above a certain dollar amount, amendments to the option plans or certain option documents including vesting schedules

Potential pitfalls: These additional protective provisions can be very onerous to the company since transactions which may only normally need to be approved by the board now require an additional approval before the company may proceed. This can cause time delays which can impair a company's ability to act quickly. Further, obtaining future consent from the investors may require the company to give the investors something in return for their consent.

In addition, because founders often hold a majority of the common which is required to approve a financing and the founders are often heavily involved in management, the request of such provisions can cause additional negotiations between the investors, the company and the founders to confer an additional benefit to the founders in order to obtain consent for the financing.

Pay to Play

2001: Rare
2002: Common; either (a) preferred convert to common if preferred do not invest in future financings or (b) preferred convert to a shadow preferred which has no antidilution protection, no liquidation preference, no voting rights or a combination

Potential pitfalls: Where there are a number of investors, this provision can cause problems where, for instance, one current investor chooses to fund a future round and the remaining current investors may not want to. In exchange the remaining current investors may condition their approval of the financing on certain additional adjustments such as imposing a down round on the company or elimination of the pay to play. The provision is most effective where there is one investor who is clearly committed to funding the company in the long term.

Armando Castro

Elizabeth A. Yee

Nuggets

Is Your Confidential Information Really Protected?

The life blood of every technology company is its confidential information. If the information is leaked to the competition, it can prove disastrous. However, confidentiality clauses in employment contracts often do not offer the protection employers are looking for.

Set out below are some useful pointers as to what to look out for:

- The clause needs to prevent both the disclosure and use of confidential information.
- The clause should not confuse "proprietary information" with "confidential information." The courts draw a distinction between these concepts.
- The clause should give very specific examples of information that the company regards as confidential — a bare confidentiality clause, or one which uses over generalised language, may well prove unenforceable.
- The clause should not purport to cover the employee's own know how.
- Avoid artificial time limits as to the period in which information is to be kept secret: the clause should have carve outs for information already in the public domain, or which is required to be disclosed by law, by regulatory authorities and by courts and tribunals.

- Finally - do not forget the Public Interest Disclosure Act 1998. If the clause is so broadly drafted that it could be read as preventing workers from making whistle blowing disclosures through the proper channels — it is void! Make sure appropriate carve outs are drafted.

For additional information, please contact Henry Clinton-Davis (henry.clinton-davis@haledorr.com).

Nuggets

Beware of Open Source Pitfalls!

Given the popularity of the Linux operating system and the increasing number of software tools and libraries available for free over the Internet, more and more software developers are tempted to use so-called "open source code" in their proprietary applications.

Investors should beware!

Many nuggets of open source code, especially those released under the General Public License (or “GPL”), are licensed in such a way that they can actually "infect" proprietary code and turn them into open source code!

Among the most pervasive GPL programs are a set of routines and libraries known by the designation GNU. Under the terms of the GPL, a proprietary software program that includes any GNU or other GPL'ed open source code must itself be released under the GPL.

That means the entire program must be released in source code form!

This approach is fine in academic and research settings where the GPL originated, but can wreak havoc on the proprietary rights that a commercial company is trying to protect.

For additional information, please contact Jorge Contreras (Jorge.contreras@haledorr.com) or Sarah Harrop (sarah.harrop@haledorr.com).

Nuggets

EMI to the MAX!

Entrepreneurs and venture capital investors are usually agreed that appropriate incentives for management are essential if the business is to succeed.

One of the easiest and most flexible ways of providing such incentives is to establish a share option scheme.

There are a variety of types of option scheme.

For UK resident participants, the most tax efficient scheme currently available is the enterprise management incentive (or “EMI”) option scheme.

An EMI option scheme is generally available to UK employees regardless of the jurisdiction of incorporation of the company granting the option.

In essence, gains achieved from selling shares originally acquired on the exercise of EMI options can be taxed at a reduced capital gains tax rate of 10%. This compares to income tax at 40% (plus national insurance contributions) for non-tax qualified option schemes.

There are certain qualification criteria which apply to both the company and potential participants before EMI options can be granted. Many emerging growth technology companies will qualify.

For additional information, please contact Chris Prout (Christopher.prout@haledorr.com).

The Essential Checklist

Are you serving as a VC director of a financially troubled company? Directors of financially troubled companies face special duties and risks ....

In many jurisdictions, when a company nears insolvency, directors owe fiduciary duties to creditors, not just shareholders:

- Conflicts may arise because shareholders are willing to risk remaining cash, while creditors want to preserve assets.
- Consider at what point the company must cease trading in order to avoid the risk of personal liability for the directors (the potential for fraudulent or wrongful trading).

If an inside dilutive financing round is contemplated:

- Be aware that inside rounds can give rise to potential conflicts and duty of loyalty claims.
- Use a special committee of independent directors if no outside pricing is possible.
- Ensure that all conflicts/interests are disclosed.
- Consider giving all preferred holders a chance to participate pro rata.

Resignation may not be the best course of action:

- Resignation will not limit liability for what has already happened.
- Resignation will result in a loss of ability to control what happens next and could make the situation worse.

Take actions that will limit further personal liability:

- Create a good record of how the board satisfied its duty of care (i.e., considered all relevant constituencies, engaged counsel, met frequently).
- Consider what other steps should be taken to minimise loss to the company’s creditors.
- Make sure all wages and taxes are fully paid.
- Don’t make your VC fund a “guarantor” – avoid making assurances to third parties to get them to deal with the company.

- Understand the implications of liquidation and its alternatives (corporate rescue procedures such as administration and company voluntary arrangement).

- Examine D&O coverage as early in the process as possible. (Are wage and tax claims covered? Will insured vs insured exclusion interfere with payments to directors?).