Venture capital investment trends

In recent years there has been a dramatic decline in public offerings and merger activity. As NICHOLAS HUMPHREY explains, venture capital investors in Australia and the United States have adopted new structuring techniques to minimise their risks in expansion phase investments.

Investors have implemented complex structuring techniques (including participating liquidation preferences, redemptions and full price ratchets) to manage their risk. However, these structures, particularly when used in down-round investments (i.e., a follow-on round at a discount to prior rounds), can significantly dilute minority shareholders (such as founders and employees).

This article is divided into the following sections: liquidation preferences, redeemable shares, anti-dilution protections, follow-on financings and veto rights.

**LIQUIDATION PREFERENCES**

A ‘liquidation preference’ provides that upon a trade sale, winding-up or liquidation, the investor (who typically holds preference shares) will be entitled to be paid some amount of money before the ordinary shareholders are paid anything.

**Non-participating preferences**

Traditionally, the liquidation preference has been ‘non-participating’ (or a ‘straight preference’). In other words, once preference shareholders were returned their original investment, they would not share in further distributions or would only participate in a limited way (usually *pari passu* with the ordinary shareholders).

**Participating preferences**

Venture capitalists are now frequently receiving a ‘participating liquidation preference’.

This means that on a liquidity event they will be returned their original investment and will then participate in the balance of the proceeds on an as-converted basis as if they had not received a preference.

In some cases they will receive a ‘multiple participating preference’, such as two times their original investment, before the ordinary shareholders receive anything (known as a 2X preference).

Some US investors have recently received 3X and 4X preferences, which have (not surprisingly) been poorly received by investee companies.

Indeed, the employees of Livemind Inc. went out on strike when the board signed a terms sheet giving the venture capitalists a 4X preference.

The terms of the investment of the first round of investors sets the ‘baseline’ for the terms of future rounds of venture funding.

According to Craig Tighe, (a senior partner with Silicon Valley law firm Gray Cary), first round investors in the US have become cautious about seeking fully participating preferred stock because if later investors get the same rights, this would significantly reduce the return to first round investors on a company sale.

**Example**

Bay Ventures invests $10m into City Wide Manufacturing (CWM) at a pre-money valuation of $30m with a 1X participating preference.

The holding of Bay Ventures in CWM is 25% of the issued capital. If CWM was then sold for $50m, Bay Ventures
would be entitled to receive their original capital of $10m plus 25% of the balance (i.e., $10m or 0.25 times $40m). In total they will receive $20m or 40% of the proceeds. If they had a 2X preference, they would receive $20m (2X their original investment) plus 25% of the balance ($7.5m), giving them $27.5m or 55% of the proceeds.

If, however, the preference was non-participating, then they would only get their proportionate share of the proceeds (in the same way as the ordinary shareholders), a total of $12.5m (calculated as 0.25 times $50m).

Capped preferences
In some cases, the preference will be capped so investors only participate in distributions until they have received a specified amount, usually a multiple of their original investment (for example, twice their original investment) or a predetermined rate of return (IRR 35%). This is really a middle ground between non-participating and participating preference shares.

The practical impact of such a mechanism is that preference shareholders will elect to convert their preference shares into ordinary shares if the return would be greater than the capped preference.

Catch-up layer
In some cases, ordinary shareholders may request a ‘catch-up’ provision such that they receive a certain return before the preference shareholders participate.

In other words, on a liquidity event, the preference shareholders will have their original investment returned, then ordinary shareholders would receive a catch-up payment and then the balance would be split pro rata between the ordinary and preference shareholders.

The amount of return given to ordinary shareholders can become quite contentious. Often founders have not invested much in the way of cash, so a catch-up layer equal to their original investment will not compensate them for their ‘sweat equity’ and lost salary. As such, the pre-money valuation is sometimes used as the benchmark for the catch-up amount.

Cascading preferences
Where a company has received multiple rounds of investment, it will be important to document the priority of the preferences between the various classes of shareholders.

Each round of investors will typically be called a series (such as Series A, Series B, Series C).

The investors who invest in the last round will often seek to have their capital returned before all the other classes of shares.

In some cases there will be a cascade of preferences between each class, so the Series C have their capital returned first, then the Series B, then the Series A and finally the ordinary shareholders. In other cases, the Series A and Series B shareholders lose their preference completely and rank pari passu with the ordinary shareholders.

US trends
A recent survey by Fenwick & West of 85 venture investments into technology companies showed that in the San Francisco/Bay Area Silicon Valley in 2003 (F&W Survey):

• more than 72% of investments had participating preferences;
• more than 35% of investments had a preference greater than 1X;
• less than 10% of investments had a preference of 3X; and
• the use of multiple preferences was declining in the later half of 2003.

REDEMPTION
Historically, investors have obtained liquidity for their holdings through trade sales or an IPO of the portfolio company.

In recent years, however, there has been a dramatic decline in both merger activity and public offerings (particularly in the technology and telecommunications sectors). Increasingly, venture investors in the United States and Australia are now asking for redeemable shares.

What is a redeemable share?
In essence, a redeemable share is the right to force the company to return the original value of the investment at some point in the future (usually after three to five years) in much the same way as a bank requires the repayment of loan principal.

It is interesting to note that the F&W Survey showed that more than 35% of investments in the Bay area had redemption provisions in 2003.

This mechanism gives the investor some liquidity if a trade sale or IPO has not occurred by a certain date.

In Australia, shares may only be redeemed from profits or from equity specifically raised for the redemption of shares.

Another important benefit of redeemable shares, relative to selling into an IPO, is that it avoids the not inconsiderable risks of prospectus liability. If an investor sells their shares as part of a public offering, they may be liable for civil and criminal penalties under the Corporations Act for any misleading or deceptive statements in the prospectus.

Downside of redeemable shares for the company
The company should note that future investors and creditors will not want to see their funds used to pay out existing investors: they would much rather they were used to grow the company. Moreover, once granted it is likely that future rounds of investors will want redemption rights as well.

One common strategy employed by companies against the request for redemption is to argue that, as it is effectively a ‘put option’ granted to the investor, it is only fair that the company have a corresponding call (i.e., the right to force the investors to sell the stock back to the company at a certain point in the future at a set price).

ANTI-DILUTION PROTECTION
Investors also invariably have embedded in the terms of their shares anti-dilution protection, which adjusts their holding in the company to offset some or all of the dilution caused by a down-round (i.e., a future investment at a price per share lower than what the investor paid).

The theory underlying price ratchets is that the valuation of a company at the time of the investment is often
highly uncertain and the investor is entitled to a price adjustment if it turns out that the company was overvalued. Anti-dilution protection is usually either a weighted average or full price ratchet.

**Weighted average price ratchet**

A weighted average price ratchet attempts to calibrate the holding based on the size and price of the dilutive round using formulas, which compare the price and number of new shares to be issued to the price and number of either:

- the existing issued share capital (known as a ‘narrow-based weighted average price ratchet’); or
- the existing issued share capital on a fully diluted basis (i.e., assuming exercise of all options and other convertible securities) known as ‘broad-based weighted average price ratchet’.

A narrow-based ratchet is preferred by investors as there is usually some uncertainty as to whether the options or other securities will ever be exercised (e.g. executive options are usually subject to vesting) and, more importantly, if you use a broad base formula, the enlarged denominator absorbs more dilution and reduces the impact of the price ratchet.

**Full-price ratchet**

A full-price ratchet gives the investors the full benefit of the new lower price, as if they had made purchase at the later lower-priced round. While simpler, this is a more draconian approach as it does not take into account the amount of funds actually raised. In some cases, the full-price ratchet expires after a certain period of time (such as 12 months from investment) or at the closing of another round of funding.

**Pay to play**

The concept of ‘pay-to-play’ is relatively unusual in Australian venture transactions, but is not uncommon in US rounds. This mechanism provides that if an investor does not subscribe for their pro rata share of future rounds, then they lose their anti-dilution protection (sometimes called a ‘put-up or shut-up’ clause). In some instances, the pay-to-play concept is also applied to liquidation preferences. In other words, unless the investor invests in future rounds, they lose their liquidation preference.

**US trends**

The use of a weighted average is reasonably common both here and in the US, although in a growing number of cases full-price ratchets are being used.

The F&W Survey showed that in the Bay area in 2002–03, the number of investments with price ratchets were as follows:

- Weighted average: 80%
- Full price: 15%
- No ratchet: 5%
- Pay-to-play: 19%

**FOLLOW-ON FINANCINGS**

A “follow-on” is a financing where investors subscribe for additional shares in an existing portfolio company. According to the *Australian Venture Capital Journal*, the relativity of follow-on rounds to new investments has increased over the last few years. Follow-ons comprised 60% of investments in the year to 30 June 2003 (compared to only 50% in 2002 and 40% for 2001).

A ‘down-round’ is a financing where investors subscribe for shares from a company at a lower valuation than that placed upon the company by earlier investors.

Down-rounds can result in substantial dilution to the founders, employees and (potentially) to existing investors.

The F&W Survey showed that there were marginally more down-rounds than up-rounds in the Bay area in 2003. The high incidence of down-rounds is really indicative of the broader trend in falling valuations. In the United States, the median pre-money valuation for a venture backed company in 2002 was US$10.9m, down from US$16.8m in 2001 and US$26.2m in 2000.

In Australia, the trend was less dramatic, with the average investment size for 2002–03 being about $2.06m (compared to $2.41m in 2000–01).

**Conflicts of interest arising from down-rounds**

Down-round financings have the potential to create significant conflicts of interest. Investors wear two hats (as a director and as a shareholder) and owe fiduciary duties in both those capacities.

The role of the investor as a director involves duties that frequently run counter to obligations to their own fund investors.

This conflict of interest is intensified by a follow-on round at a discount, where the existing investors’ nominee directors establish the valuation in the funding round in which they are participating.

There are also potential conflicts between shareholders who are protected from dilution (not only through any anti-dilution ratchets but also by their ability to invest in the new round) and the shareholders who are not protected. To compound the issue, the ‘protected shareholders’ also typically have controlling influence over the company (through board membership and contractual protections such as vetoes over the issue of new securities).

This control magnifies the potential conflict and risk of self-dealing accusations.

Ironically, the risks in a down-round financing are most likely to materialise if the portfolio company actually succeeds in turning around its fortunes and implements a profitable exit. Those shareholders (often founders and employees) whose holdings were diluted have a significant incentive to bring an action against the board of directors and controlling shareholders.

In a recent United States case, three prominent venture capitalists (including Accel and Mayfields) were sued by the founders of the Alantec Corporation for breach of fiduciary duty after approving a down-round. The interest of the founders was reduced from 8% to less than 1%. The company later went public and was sold for US$770 million.

The founders claimed they had lost US$40 million as the investors had ‘manipulated’ the stock by issuing new shares at a discount to the market price and refusing to let the founders...
participate in the funding round. The defendants agreed to an out-of-court settlement of US$15 million, presumably in an effort to minimise the risk of a jury verdict.

**Risk management techniques to minimise conflicts**

The key risk management techniques to minimise conflicts of interest when conducting dilutive financings are:

- **Rights offering**: The company should consider a ‘rights offering’ and extend the right to participate in the dilutive financing to all the company’s existing shareholders. By participating in the round, existing shareholders can retain their relative percentage interest or at least minimise the dilutive impact of the round.

- **Third party investors**: The board, subject to the company’s cash burn rate, should attempt to raise the funds in the market and conduct a wide search of potential investors. The presence of new arms-length investors adds substantial credence to the pricing as being ‘fair market value’. If the board can demonstrate it searched methodically for alternative financing and has considered each of them thoroughly, it can argue that dilution to other shareholders was the best (and last) step available in the interests of the shareholders as a whole.

- **Procedural issues**: It is easy to criticise a transaction if proper corporate governance was not followed, and such irregularity may be seized upon as elements of a litigation strategy. Investors should ensure that:
  - they disclose their potential conflict of interest and excuse themselves from board discussions and voting regarding the terms of an internal down-round financing.
  - consider appointing a committee of independent directors to negotiate the financing on behalf of the company.
  - the company has separate legal representation from the investors in a down-round.
  - board minutes are regularly and carefully kept. In particular the minutes should reveal in detail the deliberative process of the board and the difficult business exigencies (such as exhausted cash supplies) facing the company.

- **Benchmark the valuation**: Obtain evidence of benchmark valuations for companies (both public and private) in the same industry and also keep a record of the terms and conditions in funding rounds of such companies.

- **Indemnity**: In some cases in the US, investors are requiring the company to indemnify them against shareholder claims arising from the down-round.

**Employee incentive issues**

An important impact of down-round financings is the significant dilutory effect on employee stock options. In some cases the company’s founders and employees are ‘washed-out’ by the down-round so their shares or options are virtually worthless.

**Dilutory effect of down-rounds**

The dilution is driven by a combination of the reduced valuation of the company (often vastly lower than when the options where granted), plus the inclusion of multiple liquidation preferences in the new round of funding. To make matters worse, the existing investors often have protection from down-rounds through price ratchets, in effect transferring the dilutory effect of the financing to executives and employees.

Investors can also minimise the impact of dilution by exercising their pre-emptive right to subscribe for their proportionate share of any new financings at the lower valuation. Even if the founders and employees have pre-emption rights, they typically lack the capital to participate to any significant extent in the down-round.

**Strategies for re-incentivising staff**

Investors need to carefully consider the best way of ensuring that executives and employees are re-incentivised. Employees who have seen the value of their stock/options plummet after tech-wreck are justly sceptical of attempts to create new stock option plans.

In response to this, many US companies are now offering old-fashioned annual cash bonus schemes. Annual cash bonuses are easy for employees to understand and value; typically do not need shareholder
approval; and give the employee cash to pay tax.

On the downside, unlisted companies usually do not have sufficient cash balances to properly reward staff. Moreover, creating significant ongoing cash commitments can frighten away potential buyers.

Another common strategy is a promise to pay executives a cash or stock bonus if certain milestones are reached. Typically this involves a successful trade sale or IPO within a certain time period.

The amount of the bonus can be a fixed cash amount (e.g. a pool of $5m will be made available if a sale of $60m or more is achieved) or a percentage of the size of the deal (e.g. a bonus pool of 5% of the proceeds will be created if the company is sold for more than $60m).

In general, good leaver – and bad leaver – type provisions will be applied, and if an executive is terminated for cause (such as gross misconduct) or resigns before exit, then their share of the bonus is forfeited.

A word of warning: when creating any equity participation scheme, it is important to obtain independent advice from a suitably qualified adviser on not only the tax implications for the company (and the participants) of the scheme, but also the need for any prospectus or other disclosure document when issuing the securities.

**VETO RIGHTS**

Traditionally investors have allowed the board and the management of the company to have a relatively free reign and have sought only limited veto rights over such matters as changes of control, sale of assets, IPOs or issuing new shares.

Investors are now requiring a wide array of issues to be subject to their veto, including hiring and firing key staff, implementing an employee option plan, settling litigation, acquiring assets, raising debt, entering into material customer contracts, adoption of business plans and budgets, etc.

The implications of this more aggressive regime are yet to be fully determined. On the one hand it ensures continuous communication between the investee and the VC, and also fosters a more disciplined approach by investee companies towards spending decisions.

On the other hand, investors potentially risk being treated as a ‘shadow director’ and will be bound by fiduciary duties as if the fund is itself a director of the investee company.

In other words, not only might the investor’s nominee director be bound, but the fund may also be bound. The definition of ‘director’ in section 9 of the Corporations Act provides that people or entities who are not appointed as directors can be deemed to be a director if they act in the position of a director or the directors of the company are accustomed to act in accordance with that person’s instructions or wishes.

The mere fact that an investor has appointed a nominee director or has certain veto rights is unlikely to make them a shadow director.

However, the more control which is exerted over the company, the more risk of an investor being deemed a shadow director.

**CONCLUSION**

Follow-on and down-rounds create fertile ground for conflicts of interest. Investors must consider a myriad of legal and commercial issues if they are to minimise the risk of oppression suits.

Investors should comply with a strict governance regime, offer participation rights to all shareholders, and ensure all parties understand the implications of dilutory mechanisms such as liquidation preferences and full-price ratchets.

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*Australia Venture Capital Journal*, April 2003, Year 12, No. 119.


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