‘**Innovation, Strategy & Corporate Governance’ course**
Professor Mary O’Sullivan
INSEAD MBA Program

VENTURE CAPITAL AND ENTREPRENEURSHIP: RECENT EVIDENCE

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February 2002

SANITIZED VERSION

EXECUTIVE SUMMARY

Before writing this paper, we assumed that the goals of venture capitalists and entrepreneurs in the Internet era were not aligned, probably creating an important agency cost, in accordance to the theory, which we describe in part I.

- We thought entrepreneurs had the ambition to create a sustainable business, only using the investor's money to jumpstart and then grow their business.
- We also presumed the investors' goals were to try to spot a new venture early enough in order to develop a handsome return on investment, while reducing the risk as much as possible through strict financial contracting and board-level monitoring.

During the NASDAQ bubble, as the number of new ventures increased, the number of agency problems between VCs and entrepreneurs potentially increased. We surveyed more than 20 entrepreneurs and 20 venture capitalists directly involved with this period, with a particular focus on early stage companies, trying to understand how effective where the corporate governance mechanisms in controlling these agency costs.

In part II, we identified three clear stages in the relationship:

- Finding the right partner, ie matching the entrepreneur with his investors
- Negotiating the relationship with legal provisions
- Monitoring the growth of the new venture (including the incentive mechanisms)

In the first stage, we found the matching of entrepreneurs and investors to occur in an inefficient market where, most often than not, entrepreneurs could not find the right investor for their venture. For start-ups, particularly with an inexperienced management team, we found the investors to have a strong negotiating power to make or break the deal.

In the second stage, we found that the parties spent a great deal of time discussing particular clauses of contracts, although 90% of all term sheets are the same. The due diligence process also delayed the development of the new ventures. Interestingly, both parties recognize that although they spent a considerable time developing the legal framework of their relationship; in practice applying the contract clauses proved a very difficult task, with the exception of the right to revoke top management.

In the third stage, we found that the preferred tool to monitor the progress of the relationship was through the Board of Directors. However, most VCs expressed a growing trend to act as non-executive Board observers, so as to escape from potential liability suits thereafter. Additionally, some of these Boards proved less and less effective as they grew into a rubberstamp role, with virtually all decisions negotiated beforehand.

Finally we explored the effectiveness of incentives in this context. We found that as they were becoming a commodity and standardized, stock options were merely symbolic and proved of little retention and motivation value to both employees and management, as they would be worthy only in the case of an IPO. Bonuses and variable salaries were also used, but management tended to discard them as they created wrong incentives for employees, developing a focus on short-term and individual performance. Base salary was granted according to industry average in order to cover for living costs. Finally, the only effective incentive tool seemed to be equity ownership for top management who then somehow understood the shareholder perspective.

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Part I – Theory - why is this a big issue; why is it more acute in the VC industry?

There is ample academic literature on financial contracting, specifically on the conflicts of interest (agency problems) that emerge in new ventures when an agent (entrepreneur) needs financing from a principal (investor), which provides the funds[1]. As outlined by Kaplan and Strömberg (2001), theory has identified three main ways though which the investor, in this case venture capitalists, can diminish these risks: investment screening, financial structuring (allocation of cash flow and control rights), and ex-post monitoring, all of them being closely related. "In screening, the VCs identify areas where they can add value through monitoring and support. In contracting, the VCs allocate rights in order to facilitate monitoring and minimize the impact of identified risks." (Kaplan and Strömberg, 2001). Additionally, the widespread majority of VC financing attempts to optimise the outcome of the investment and minimize potential agency costs by using convertible securities, by syndicating the investment and by staging capital infusions. Each of these areas brings a big field for theoretical and empirical research of its own.

This paper investigates the early stages of new corporate venture financing, specifically what are the common features of deal structuring and how performance is monitored. Our empirical focus is on new high-tech ventures. The business of financing new ventures, especially high-tech, which has a broader set of possible states of nature, differs significantly from more mature investments, as it involves several risky aspects. First of all, it is normally the case that independent new ventures carry much more risk than more mature companies, implying that investors require a significantly higher risk premium to provide financing. In addition, information asymmetry is potentially more important in new ventures, where the entrepreneur normally has much more information of both the state of the venture at a certain date and of the likely state in future periods. Such situation may potentially generate severe conflicts of interest, requiring investors to search for protection in the case of poor performance of the venture.

Corporate finance theory investigates agency problems and how shareholders and management may design contracts to align interests, normally in the form of collateral and covenants in the case of new debt financing. However, given the higher risk associated with new ventures, agency problems may become more critical than those taking place in well established companies, and therefore different and more stringent mechanisms to align interests of investors and entrepreneurs are normally required. On the one hand, it is important to adequately balance financial incentives, costs and risks for the entrepreneur, in order to maintain entrepreneurial activity and minimize the risk that he or she will attempt to increase private benefits at the expense of investors. On the other hand, it is important to design financing agreements in which investors have the adequate mix of satisfactory returns, in the case of a good performance of the venture, and mechanisms of gaining control and interfering in management in the case of bad performance.

Other aspect of the problem, in general confirmed in empirical research is the fact that "the equity allocated to VCs provides incentives to engage in costly support activities that increase upside values, rather than just minimizing potential losses" (Kaplan and Strömberg, 2001). In fact, the literature suggests that the role of VCs extends beyond that of traditional financial intermediaries and that they play a broader role in the professionalization of the start-up

[1] See, for example, Gompers (1995), Sahlman (1990), Berglöf (1994), Kirilenko (2001) and Hellman (1998)

companies they finance (Hellman and Puri, 2001). This is the monitoring and adding value aspect of VC involvement, which seems to be broad.

The paper is divided in as follows. In the remaining of part 1 we briefly discuss the literature that investigates allocation of control and cash flow rights between VCs and entrepreneurs, focusing on the various aspects involving financial contracting and monitoring. We also describe terms and clauses of actual contracting, discussing the more important and common clauses and offering evidence that VCs behave in accordance to theoretical control theory. In part 3, we provide additional empirical findings, especially in terms of anecdotal experience of VCs and entrepreneurs of what can go right/wrong in practical life, in spite of carefully designed contracting and monitoring. And finally, in part 4 we conclude.

Financial Contracting and Structuring

Following Kaplan and Strömberg (2002), "a key feature of VC financing is that they allow VCs to separately allocate cash flow rights, voting rights, board rights, liquidation rights, and other control rights." In terms of cash-flow rights, classical principal-agent models assume that the agent's effort is unobservable to the principal. The conflict exists because the entrepreneur has to give back to investors a return of part of the value created in the new venture. As we said above, in the case of new ventures the potential conflict is heightened by the very nature of the business, which carries more uncertainty. If investors knew all potential outcomes, state contingent contracts would be able to solve any potential agency cost. But complete knowledge does not exist, in which case the best investors can do is try to minimize these costs. For example, entrepreneurs might invest in projects that may have high personal benefits, but low or negative return to shareholders. In this sense, the uncertainty surrounding new ventures is not only caused by the external risks, i.e. those risks associated with uncertain commercial acceptance or applicability of a new technology or business concept, but also by internal factors to the new venture. Following Lauper (2000), "information asymmetry between entrepreneurs and investors leads to four types of agency problems: (i) not working as hard as investors expect, (ii) taking actions that yield private rather than monetary benefits, (iii) spending resources on perks and (iv) holding up the investors by threatening to leave." And lastly, the value and viability of a new venture rely significantly on intangibles, which are difficult to value, and for this reason pose another set of challenges for appropriate contracting.

The allocation control rights become important in the case when actions are observable, but not verifiable, as in the incomplete contracting models of Grossman and Hart (1986) and Hart and Moore (1988). Such is the case when the entrepreneur derives a private benefit from running the company, which is not known by the VCs, who seek only to maximize financial returns. These benefits provide important incentives for the entrepreneur, but are hard if not impossible to specify in a contract. "Control is important because it affects the non-contractible behavior of two contracting parties" (Hellman, 1998). Therefore, "voting and board rights give the controlling party the right to decide on any action that is not pre-specified in the original contract. Such rights are valuable in an incomplete contracting world, when it is not feasible or credible to specify all possible actions and contingencies in an ex ante contract." (Kaplan and Strömberg, 1999). Contracts will be incomplete, in spite of contingent contracting in the real world, and there will be a disproportionate distribution of control rights comparing to actual equity holdings. In particular, contracts are likely to assign to VCs greater control rights the more asymmetric the information potentially is. Entrepreneurs may therefore have to relinquish control in early stage ventures financed by

VCs if uncertainty is sufficiently high. Indeed, empirical evidence indicate that VCs are likely to be in control more often in early stage ventures that do not have a product yet in the market, than in more advanced companies. Other evidence in this direction, meaning VCs having more control the more asymmetric is the information, or at least potentially asymmetric, is that "serial" entrepreneurs are more likely to succeed in maintaining control than are new entrepreneurs with no track record.

Other important feature is that cash flow rights and control rights may be separated and made contingent on observable variables of performance, financial or non-financial[2]. In terms of the separation of cash flow and control rights, it may be achieved in various ways "including unvested stock options (which do not have votes), non-voting stock, contracts specifying a change in equity ownership at the IPO, or explicit contracting on the right to exercise votes depending on performance targets"(K&S, 1999).

In terms of control rights, theory builds on the incomplete contract framework to model contingent transfer of control between entrepreneurs and VCs. Aghion and Bolton (1992) derive the conditions under which the entrepreneur would cede control contingent to certain states of nature, in which investors would gain control. In particular, the assumption is that the entrepreneur is wealth constrained and wants to keep control, as a way to accruing valued private benefits of running the company, benefits which are not verifiable by investors. But the need to provide a minimum return to investors may force him to cede control. Following K&S (1999) " Aghion and Bolton show that as the external financing capacity of the project increases (i.e. the higher the profitability of the project and the lower the conflicts of interest), control moves from more investor control to more entrepreneur control. In particular, for projects with high external financing capacity the entrepreneur always should have control. As external financing capacity decreases there should be state-contingent control, similar to a debt contract that transfers control to investors only in bad states of the world. Finally, for projects with low external financing capacity, the investor should always be allocated control. In particular, the securities prevalent in investment deals are normally convertible preferred stock or convertible debt, or even a combination of debt and equity, in order to assure that the allocation of control between the entrepreneur and investors is made dependent on performance. In this sense, the deal allows a higher share of control for the entrepreneur in the good state, i.e. allows the entrepreneur to collect a higher share of the benefits in the case of good performance, but transfer control rights to the investors in the bad state."

Financial contracting in practice

Contractual clauses in VC financing deals will typically deal with all these potential problems. As a result of all this factors, an optimal incentive contract should (1) deal with agency problems caused by external and internal uncertainties (risks, by aligning the incentives of the agent with those of the principal, meaning designing the entrepreneur's compensation to be conditioned on performance, increasingly so the more acute are asymmetric information problems, in order to increase entrepreneurial effort; clauses to allocate cash flow will typically include vesting (performance and/or time); (2) include provisions to shift control to investors in bad states of nature, to assure that negative actions in the point of views of the shareholders; (3) include clauses of monitoring to allow investors to

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[2] Financial milestones could be minimum levels for earnings and sales growth. Non-financial performance may take numerous forms, from FDA approvals for biotech, to reaching commercial level for a new technology or even a minimum number of active on-line clients, in case of dot.coms.

have accurate information in a timely basis, in order to minimize potential information asymmetries, mainly for internal risks, (4) in order to minimize the incentive of entrepreneurs to adopt aggressive behavior and force him or her to work under constraints, VCs typically stage their investment in various rounds[3], conditioned in milestones of performance and permanent monitoring. The terms include anti-dilution clauses to allow the VCs to control additional financing sources.

Indeed, evidence also suggests that VCs behave according to the theory, having more rights in bad states of nature than in good states, in all aspects, ranging from cash flow rights, control rights, board rights (K&S, 1999 and Lauper, 2001), to other clauses such as exit rights, liquidation rights, anti dilution protection, vesting, among others.

Cash flow rights

Cash flow rights are the proportional claims of various equity holders. In K&S (1999), evidence confirms that VCs change the entrepreneur's equity compensation function, making it more sensitive to performance when incentive and asymmetric information problems are more severe. Indeed, K&S (1999) investigate post-round allocations of rights for 213 investments made between 1987 and 1999 in 119 portfolio companies by 14 venture capital partnerships find that VC equity stake is 8.8% higher under low vesting and bad performance of nature than under full vesting and good performance. In the worst case, the share of venture capitalist is 55.5%, comparing to 46.7% in the best case. In addition, early stage venture deals are more likely to have clauses of time vesting, given the high importance of human capital of the founder to the success of the investment.

In terms of the kinds of securities issued, theory indicates that optimal contracting should take the form of a convertible security, in order to protect investors in the bad state, through the bond feature, and allow them to benefit in the upside, through the conversion feature. Therefore, agreements will typically issue convertible preferred stock, or some combination of debt and equity. Berglöf (1994) proves in a model that convertible debt always dominates pure debt or pure equity, or any combination of these two instruments.

In the survey of K&S (1999), convertible preferred stock is found to be "the most commonly used security, appearing in 204 of 213 financing rounds. However, VC financings (1) do not always use convertible preferred stock; and (2) frequently include securities in addition to convertible preferred stock. Only 170 of the rounds are financed solely by convertible preferred stock." However, only the small minority (7 out of 213 rounds) does not use any form of convertible security at all, relying in "multiple classes of common stock or a combination of straight preferred and common stock".

Voting and Board Rights

Voting rights are relative number of votes that VCs and entrepreneurs have in the various states of nature. Board rights are the number of seats allocated to VCs and entrepreneurs. Board rights and voting rights may differ, depending on the distribution of the securities issued in the agreement, in the form of common stock, preferred stock and so on. Again,

[3] It is less common, but we found in one of our interviews that VCs may sometimes be the aggressive ones, pushing the entrepreneur to burn the cash if they believe it is in the sake of the venture. In the internet bubble, it is likely that some VCs were those that were pushing hard, believing in the "first mover advantage" motto.

evidence shows that actual agreements are in accordance with theory, shifting more control to VCs in bad states of nature, both in terms of board rights and voting rights.

Again based on K&S (1999), for first round financing, the voting rights percentage of VCs in the bad state of nature is 12.6 percentage points higher than in the case of good performance. VCs hold 58.9% of voting rights in the bad state, comparing to 46.3% in the good state. Entrepreneurs hold 29.8% in the bad state and 42.9% in the good state. However, in any state, voting rights of VCs are higher than what would be proportional to their share of total equity, as the voting/cash flow ration is 1.16, in both states of nature.

In terms of board rights, again the evidence seems to support theory. K&S (1999) "distinguish between normal board rights that reflect the board rights or composition at the completion of the financing from adverse state board rights that reflect board rights or composition if the portfolio company performs poorly or reaches an adverse state." The average board has 6 members. VCs have control of the board in 25% of the cases in all rounds, and only 11.6% in first round, indicating that they gain more control after additional rounds. However, 18% of the agreements have state contingent board provisions, in which VCs gain control in a bad state. Indeed, in the case of bad performance, VCs hold control in 35.8% of the cases in all rounds and 27.8% of the cases if the first round is considered alone.

In addition to voting and board rights agreements include hiring & firing provision, which allows VCs to interfere and change management contingent to certain performance measures, or events. We discuss these provisions below in monitoring, showing that deals more often than not include hiring and firing provision, effectively giving to VCs the control of the board, even in situations when there is no majority in the board.

Other clauses

Other important clauses commonly find in agreements are anti dilution protection, vesting and non-compete clauses. Anti dilution aims to protect the investor against future financing rounds that might be done at a lower valuation comparing to the valuation in which the VC provided the original first round financing. The protection may be complete, in the form of full ratchet, or partial, in the weighted average ratchet. In the first case, the complete protection is achieved by entitling the original VC with enough new shares to reach the new implied share price of the new financing. In the second case, anti dilution protection is not complete. Anti dilution protection is overwhelmingly present in agreements. K&S (1999) find in their sample that 95% of the agreements include such clauses, 78% of which being in the form of weighted average ratchet.

In terms of vesting and non-compete clauses, the motivation is (1) to provide incentives for the entrepreneur to work hard (performance vesting) and (2) to retain the entrepreneur in the firm by raising the cost his cost of leaving the firm (time vesting and non-compete clause). Given, that the obligation of entrepreneurs to stay with the firm is not contractible, such clauses can be used to achieve similar results. Vesting provisions are also very common. K&S (1999) find that vesting is present in 41% of financing rounds and non-compete clauses in 70% of financing rounds.

Monitoring

In addition to financial contracting, evidence suggests that VCs engage in active monitoring the start-ups and providing of advice to management. This makes sense, as the allocation of equity to the VCs, in its various possible forms of convertible preferred, participating preferred or common stock, provides them the necessary incentives to engage in costly information gathering, monitoring and advisory activities, in an effort to add value to the venture and benefit from a potential upside. Indeed, agency theory indicates that VCs should be active board members, as they have interests closely aligned to those of stockholders: VCs are directly selected by investors (the limited partners) and have a large component of their compensation tied to the success of the companies in which they invest.

Monitoring being not specific to VCs, as inside investors in general normally engage in some form of relationship with the firms they finance. However, monitoring requirements and incentives may be even more pronounced in the case of VC investments than would be the case with other financial investors involved in more mature companies, given the greater presence of VCs in the financing of early stage ventures, which in general have few tangible assets. Uncertainty is thus higher, given these new ventures greater reliance on intangibles. Therefore, incentives for monitoring exist in addition to more stringent requirements in terms of financial contracting.

There are various ways through which VCs monitoring and contribution to new ventures may be investigated. Several authors try to model how the monitoring of VCs affects the performance of new ventures. For example, Hellman and Puri (2001) study 173 start-up firms in Silicon Valley and try to identify the effects of VCs monitoring through the differences in terms of professionalization of the new ventures. Specifically, they measure the time difference in which early stage companies with VC funding bring a product to market, comparing to non-VC funded companies. Other aspects investigated is the relative professionalization of senior management, in the form of hiring an outside CEO and/or a vice president of sales, and of adopting stock option compensation plans to employees. They find that VC financed companies are quicker to bring a product to the market and are quicker and more likely to hire outside senior management, including an outside CEO. VC funded companies are also more likely to adopt option plans to employees. In conclusion, Hellman and Puri (2000) find "that venture capitalists play a significant role in the development of the start-up companies. The influence of venture capitalists concerns not only the choice of the CEO, but it also seems to extend further down into the organization. The presence of venture capitalists can have a "soft" facet, in terms of providing support for building up the human resources of the company. But it may also have a "hard" facet, in terms of exercising control over CEO leadership changes, possibly at the cost of having founders leaving the company that they created". Additional evidence of influence of VCs in senior management of companies is provided by Lerner (1995), who concentrates in VCs representation on the boards of private firms in their portfolios, in a sample of 307 biotech firms. He finds that "changes in the board membership around the time that a firm's CEO is replaced. The replacement of top manager at an entrepreneurial firm is likely to coincide with an organizational crisis and to heighten the need for monitoring. An average of 1.75 VCs are added to the board between financing rounds when a CEO is replaced in the interval. No influence are found in the addition of other outside directors." Without CEO turnover only 0.24 VCs are added to the board between financing rounds.

In addition, research also indicates that VCs have a broad role in the professionalization of the firms they participate. Hellman and Pury (2000) indicate that “the evidence presented hints at a broader role, where the financial intermediary (in our case the venture capitalist) promotes certain business processes (in our case professionalization of a start-up).” Kaplan and Strömberg (2000) go in the same direction and find in their survey “that in 14% of the investments, VCs play a role in shaping management team before investing and in 50% of the investments, VCs explicitly expects to play a role after investing. Sometimes this involves replacing a founding manager, but more often it is an issue of strengthening and broadening the existing management team by hiring experienced executives. Moreover, in more than a third of the investments the VC expects to be active in other areas, such as develop a business plan, assist with acquisitions, facilitate strategic relationships with other companies, or designing employee compensation”. Such evidence is confirmed in our research, as described in section 3, in which the majority of the VCs interviewed answered that “always” or “sometimes” to the question whether they were involved in the operational activities of strategic planning, human resources, sales and marketing and finance.

However, these studies seem to infer that VC advice and involvement is normally a good thing, in terms of the quality of their contribution for the professionalization of the companies they are involved in. That may not always be the case, as the stereotype is that VCs are known to have time as the scarcest resource. Indeed, again following Kaplan and Strömberg (2002) research, in 20% of the investments studied “the VC was worried that the investment might require too much time”. VCs want to be involved, but not too much involved. That may be problematic, as Steier and Greenwood (1995) provide anecdotal evidence from case study (acknowledging the need to verify if the findings may be generalized) that “the operating logic of venture capital networks, constrained by the hierarchical structures of their constituents, may be incompatible with the needs of a start-up firm” and that “paradoxically, VCs establish milestones and tight time-lines yet inadvertently contribute to many of the delays experienced by a start-up firm.” These findings are inserted in the main focus of their study, namely the potential problems in “the process of new venture creation involved staged financing and multiple venture capitalists”. Indeed, another aspect of our anecdotal evidence provided in section 3 is the permanent starvation of cash among new ventures caused by the logic of staged financing and the conflicts that can emerge not between entrepreneurs and VCs, but among VCs themselves, who are co-investors in the same new venture.

In conclusion, it seems that actual contracting is in accordance with the theory, at least in its broader aspects: financing agreements between VCs and entrepreneurs include clauses to minimize potential agency costs, drive incentives, allow monitoring and contingent shifting of control.

Part II – Empirical evidence – does it work?

In part I we provided a brief description of the theory and empirical evidence on actual contracting practices between VCs and entrepreneurs.

In part II, we attempt to offer additional field evidence of these practices, specifically based on recent examples related to the New Economy and the biotech sector. Our sample is composed by more than 40 interviews equally split between investors (early stage to later stages) and entrepreneurs. We tried to go beyond just the testing of certain hypothesis about financial contracting in practice and monitoring, offering examples of how these practices differ from theory and textbook recommendations. There is a cost in that, in which it is very difficult to extract some generalities, as it would be the case with very specific econometric tests, but there is also a benefit in which we can learn about the industry know-how.

In a nutshell, we asked our interviewees: "how did YOU do it?" and "did it work for YOU?"

Financing a new venture, a standardized process.

We shall first present a simple scheme showing the typical financing of a new venture. We shall show that structurally, entrepreneurs are bound to loose control of their company to their financiers approximately at the time of round A.

Our scheme presented in this paper introduces several players, which for simplicity, are categorized as:

1. **Love money** – this includes the original **founders** of the company, and often a few **friends or family** (F&F), that basically fund the writing of the business plan
2. **Seed money** – Once a draft business plan is ready, it is enough to get wealthy individuals interested in the venture. They are called **business angels**, for they not only provide money, but also hands-on experience on how to run a company or on an industry.
3. **Round A** – this usually involves more professional investors, specializing in high-risk investments. They are called **Venture Capitalists**, and will be the focus of this research paper.
4. **Round B** – once the business concept is proven such as with a technical pilot running with a couple of clients, the business is mature enough to consider expansion. They will then target larger players in the VC industry. We shall call them **funds**.
5. **Round C** – oftentimes, once the company is successful, it will go public through an Initial Public Offering (IPO), underwritten by **Investments Banks**. These banks sometimes also invest in a pre-IPO round.
6. **IPO** – this is when the company goes **public**. Most importantly, this is when most restrictive provisions in the term sheet expire and are cancelled.

	Love money	Seed money	Round A	Round B	Round C	IPO
Investor money	0,1	0,15	1,6	8	22,5	100
Average time between rounds (years)		0,5	0,5	1	1,5	1
Pre-money Valuation (m$)	0,1	0,5	8	40	150	400
Founders (& F&F)	100,0%	65,0%	52,0%	41,6%	35,4%	26,5%
ESOP		5,0%	4,0%	3,2%	2,7%	2,0%
Seed (Business Angels)		30,0%	24,0%	19,2%	16,3%	12,2%
Round A (VCs)			20,0%	16,0%	13,6%	10,2%
Round B (Funds)				20,0%	17,0%	12,8%
Round C (iBanks)					15,0%	11,3%
Public markets						25,0%
	100%	100%	100%	100%	100%	100%

Our scheme uses four assumptions for describing the change in equity structure during the life of a start-up:

1. We assume that all new investors (or syndication of investors) in each new round **invest at approximately 25%** of equity post-dilution of previous shareholders. These figures are consistent with the results from our questionnaires.
2. We have assumed that all **classes of equity are fully dilutable**. In the appendix we discuss some particular protection provisions that prevent this, and allows investors not to have their equity stake diluted.
3. We assume that an **Employee Stock-Option Plan** (ESOP) is introduced at the same time as the seed financing, in order to attract talent. We have set it at an industry standard of 5%.
4. Finally, **average company valuations** at the different stages of financing were checked against industry data.

From our model, and in practice, we find that the Entrepreneur is bound to loose the majority control of the company between round A and round B, as VCs take over control of the company by appointing more Board members than the number of Directors representing the founders and/or management.

From our research we have found that the typical number of Directors is five (the range is from 3 to 7). However VCs tend to over-represent themselves, usually having 3 out of 5 Directors.

Typical clauses in a term sheet – an abuse of power?

From conversation with VCs, it seems the earlier the transaction, the more restrictive its terms are. Most provisions actually also expire when the company goes either public or is sold. From our research 90% of VCs use the same terms and clauses laundry list, basically to protect them from a downside.

- [redacted], managing partner of [redacted]. in Ontario, Canada comments: "in A rounds, we inevitably have a ratchet, usually double dip terms, require a Board seat, have controls on major expenditures, and the right to approve business plans, and have a 'disaster' clauses that let us take control if disaster scenario occur. As the companies mature, these terms are either modified or eliminated".

- [redacted] remembers: "we met many institutional investors in the process of fund raising (we got 7 term sheets signed) and noticed that almost all the terms and conditions were the same, both in terms of valuations (strongly affected by short term market sentiment) and typical Shareholder Agreement clauses."

One of the clauses founders dislike most is the ratchet clause that protects VCs from a down round valuation.

- [redacted], VP business Development with [redacted] Inc, comments: "[the full ratchet clause] is dysfunctional as it negates the founder's willingness to seek additional investment in today's climate. This makes stock options unattractive if directors hang onto their old "fair market value. The pro argument is that is forces founders to think "revenue" as the solutions to cash constraint".

The other clause that comes up most often into discussion is the preferred liquidation rights.

- [redacted], CEO of [redacted] Inc, an electronic trading platform for derivatives, comments: "the financing is fairly restrictive in a liquidity event as the VC has extensive liquidation rights. Founders are also restricted in effect by a strict vesting schedule."

Finally, a few Entrepreneurs stressed that they spent more time raising money for successive rounds, than actually running and developing the business, partly because the market required a shortened cycle between financing rounds, and partly because the market stiffened after the Internet bubble and most VCs freaked out. Also, raising money became a painful process taking approximately 6 months: 2 months to find the right partners, 2-3 months for the due diligences and term sheet negotiations, 1-2 months for the money to be delivered.

- [redacted], CEO of [redacted], a group buying site recalls: "I started the company in September 1999 and had raised enough money to cover our burn rate for 9 months. I started looking for additional funding in February. The market was booming and financing was easy. I was about to conclude by series B financing in April, when the market crashed. Everyone backed out. Until the company went bankrupt in September 2000, I literally spent more time raising money and performing public relations, than effectively managing the company."

- [redacted] explains the due diligences delays: "the time before actually receiving the cash after a deal had been agreed in principle was very long, 3 months. This due diligence period had a large negative impact on the operations of the company, as we were unable to make good on claims to key suppliers."

The theory described in part I should have led to sound VC practices in screening of deals, term sheet negotiations and effective monitoring of management of new ventures. We focus here on empirical evidence trying to support or invalidate the above statement. This evidence was gathered through more than 40 questionnaires and interviews with both VCs, represented by both General partners and associates, and Entrepreneurs, represented by CEOs and/or co-founders. Please refer to our appendices for a full list of names.

Screening of deals and partners

The Venture Capital point of view

On the one hand, empirical evidence shows that although VCs have put a significant effort in developing a lean process for assessing new ventures, the entrepreneurs themselves seldom go into that much trouble.

The usual criteria for a venture capitalist for financially assessing a new venture are:

1. Size of target market and expected market share
2. Management's ability to execute the business plan
3. Competitive advantage or barriers to entry

- [redacted], EMEA Director for [redacted] comments on the competitive advantage: "[redacted], the largest corporate venture capital organization in the world, is fairly centralized in approving deals. Every Wednesday is deal day, when people present prospective deals to management. […] EMEA presents back to Santa Clara in the afternoon, and Asia Pacific in the early evening. The management review committee has an unparalleled window into what is going on around the world. Most venture capital funds are run much more locally. We find technologies in places we never dreamed of, and when we have two or three presentations in a particular space, we can spot a trend before most others can". [[redacted] Case by [redacted], INSEAD 2002]

Young VCs will not have developed the right set of skills to assess properly these 3 criteria before dealing with several ventures and a variety of portfolio companies. More experienced VC partners however will apply either these criteria of a variation of them.

- [redacted], Senior Principal with [redacted] Europe, comments on the gray-hair ability to grow a company. For him industry experience is not enough, and should be completed by a sheer desire to succeed and an ability to work with constraint resources:

  "I don't want to undermine the industry experience - it's VERY important! But it's no less important to be able to work (i.e. fight a survival war) in a very different context - that of extremely limited resources, which do not always allow to reduce all risks and covering for all outcomes.
  On a more personal level, start-up executives also need to do much more without the typical support infrastructure they normally have in big companies - I don't mean secretaries, but mostly professionals in numerous domains (or even mentors) to whom one have an easy access within corporations.
  Basically it comes down to a question - does this person have enough guts & energy to win a fight alone, without a "big army" backup?
  This is part of execution risk, that should be taken into account, when judging an individual." [Discussion captures from a chat room for the VOBM course, 13/02/02]

VC however seem to have recognized that they should add more value than just their name on the business plan and their money.

- Leveraging internal capabilities: "as a result, in the future we will probably be somewhat more proactive with our portfolio companies by leveraging our existing infrastructure. For example, we have [redacted] resellers and have employees who work with them all the time. Certain portfolio companies might benefit from being introduced to the right channels. We also will try to make rights introductions inside [redacted]. We recently tool a look at the top [redacted] companies in our portfolio, and asked how we could help them, for example by having a couple of engineers help them for a limited time help them look into technical issues." [Anderson 2002]

The Entrepreneur point of view

On the other hand, many an entrepreneur have told us that first-time entrepreneurs have had hard times finding the right financial partners for their first venture. In their own words, "beggars do not get to be choosers".

- [redacted], CEO of [redacted].com (filed for bankruptcy) comments: "the timing was not right for raising money and investors despite their huge interest were not in a hurry to invest. We first tried to select investors with the potential to help us expand throughout Europe and with good links in their portfolio. However we had to resort to approach smaller VCs when we failed with our first choice".

- [redacted] of [redacted]. in Amsterdam confirms: "VCs choose the investment rather than the other way round. Other means of financing were not available to us at a sufficient scale".

- [redacted] shared with us the funniest way to find a VC: "I bumped into the VC on an airplane and he liked the idea. No VC approached in the conventional manner was interested so we took what we could get. Tough market."

Instead of going to a traditional VC, some entrepreneurs tried to approach industrial partners, hoping to get less strict financial terms and to leverage their industrial expertise and connections. Oddly, we did not find evidence of successful partnerships here.

- [redacted], co-founder of [redacted] in Italy explained to us why: "we started with a big industrial investor, in a time when relatively easy VC funding was still available, with the plan to build a long-term relationship and leverage potential operating synergies.
  This way, even going through a very tough time in the financial markets, the company was 'protected' in the most critical phase of its life (pre-revenues), on the other hand, the big industrial partner drawbacks have been a slow speed to implement synergies and the continuous need for diplomacy not to hurt each executive's agendas (for a big company CEO, a small startup is more often than not at the bottom of its priorities).
  The lack of a clear strategy and a strong commitment of the industrial investor in terms of operating synergies led the company to stall, as most of the management resources were wasted in endless discussion, rather than in pursuing a sales strategy.
  We eventually decided to open up the capital to a VC, very focused on our business sector, with a potential to bring value (in terms of sales, products, contacts…) to the table. A financial investor is more predictable in behavior, and transparently aligned with the management (at least while thinks are OK). Since we had several months of sales history when we closed the deal with the VC, it was much easier to agree upon and accept milestones).

Another consideration has to be taken into account into these matchmaking dances, in order to explain the increase in number of meetings and cynicism of both parties. Meeting with VCs is also a great opportunity for aspiring Entrepreneurs to refine their original concept and benefit from the VCs experience without having to pay for professional services fees.

- [redacted], founder of [redacted].com in France confirms: "I was getting better at negotiations with investors as I was taking into account and acting upon the comments I got in my early meetings".

- [redacted] of [redacted] had the same experience: "what makes us improve is presenting our project and company to new potential investors"

On one interview, we came across a specific example of hidden agendas for backing a new venture, by a very large player.

- [redacted], formerly CEO of [redacted].com reflects: "the company was a joint-venture between [redacted] and [redacted]. The reason why [redacted] entered into the joint-venture was not for the business opportunity itself, but because they wanted to build a strong relationship with [redacted]. [redacted] was about to go public and it would have had a tremendous value. At the same time, [redacted] was trying to back [redacted] for the IPO and [redacted] did not want to loose the upside opportunity." "On several occasions I asked [redacted] for resources and decisions, but they weren't properly involved. When the possibility of IPO vanished, [redacted] pulled out from the venture and the business was liquidated."

With such a harsh market, how could these investors add any value if they were not targeting the right companies? Luckily, we found the outcome can be great if the Entrepreneur gets to choose its financial partner.

- [redacted], co-founder of [redacted] Ltd, a virtual tours service provider in [redacted], recalls: "we ran in parallel with a group of private investors and a dotcom VC. At the last minute we chose the former (Thank God!) […] Who could provide cash was the principal short-listing step – then whom we felt most conformable with. We definitely made the right choice because the dotcom VC has all but disappeared, […]. Without the money we couldn't have grown at all. We now dominate our sector in [redacted]."

Some Entrepreneurs knew from the get-go that they wanted to retain control of their company. Some of them were even very successful with this approach, probably because they understood the basics of running a company: the best money is profitable money from clients paying for a service. Others are more dubious about what the alternate outcome might have been.

- [redacted], founder and CEO of [redacted].com (successfully sold to [redacted] Corp for $50m) writes: "we consciously did not engage VCs. I wanted to retain control over the vision and direction of the organization". "We did not pursue or receive any outside funding other than an initial guaranteed loan, and later we had an open line of credit with SV Bank in Palo Alto. All growth and expenses were covered by revenue".

- [redacted], co-founder of [redacted], Inc in Boston (having raised $10m in round A, and $12m in round B) confirms: "we specifically decided to go with private funding to avoid the restrictions imposed by VC groups. The one tranche of VC investment we did receive is considered as "private" investment from the VC firm and thus does not require any of their involvement in company governance. We turned down a $3m term

> sheet from a NYC VC firm due to the high-degree of involvement they proposed." "This was a somewhat contentious issue among the board members and management team. I felt that we could have benefited from raising more money and taking on the added restrictions and guidance from an institutional partner. We decided to stay from VC funding and take less money so as to maintain control and equity. This course may have been more stable, but it definitively slowed our progress vis-à-vis expansion and technological development. I'm still undecided as to which would have ultimately been the wiser move."

Hence aspiring Entrepreneurs often ended up not with their partner of choice, but with the only partner they could find. We believe that this original misfit often lay ground for conflicts down the road. If the match was not perfect at the beginning, why should it be successful down the road?

We have also found evidence that second-time entrepreneurs have learned their lesson well.

- Indeed after having sought 'well connected and branded' money with [redacted], the all-mighty founder of [redacted], entrepreneur [redacted] lost control of this company to him, although he retained a 95% equity majority. Now in the process of raising money for his second venture, [redacted] is definitely looking for "dumb" money, which will allow him to retain full control of his company [from interview of [redacted], February 2002].

- [redacted], managing director with [redacted], a software startup for the telecom industry confirms: "we selected the wrong VC in our round A: the amount invested was too small to generate any interest on part of any future investor"

Deciding on the right valuation and equity give away was tough

- [redacted] explains: "a (relatively) low series A valuation is a double edged sword: it make it easier to have an uptick in valuation for new investors, but it also limits the size of future rounds. It also becomes a credibility issue with certain counter parties."

- [redacted] of [redacted] comments: "too much [money] has never helped: [startups] blow it and the new round invariably turns into a down round and everybody cries."

Negotiating the relationship

Differences between the US model and the European model – basically an asymmetry of information & ostentatious speculation

The frustration of having missed the early days in the US market led to less-carefully selected investments in the European market or less carefully crafted agreements, in order to get the deals signed.

Many large venture capital firms in the US missed the boat in the early 1995 days when the largest deals got funded (Amazon, eBay, Ariba). Hence when the European market started developing in early 1999, most VCs jumped in, trying not to miss the boat again. Several anecdotes support this claim.

- "One thing we really have noticed in Europe is that venture capital organizations here who are co-investors tend not to be company builders" – [redacted], Director, [redacted] [Anderson 2002]. "European Venture Capital is a lot closer to the model in the eastern United States than it is to Silicon Valley". "They are interested in ownership terms, restructuring, and so on." (ditto)

- "A fundamental reason why Silicon Valley has been especially successful in creating companies is that people there understand what drives a true entrepreneur. Most entrepreneurs in Silicon Valley didn't start a business for the money. They had a burning passion. […] They wanted to change the world, they didn't start companies just to make money. (ditto)

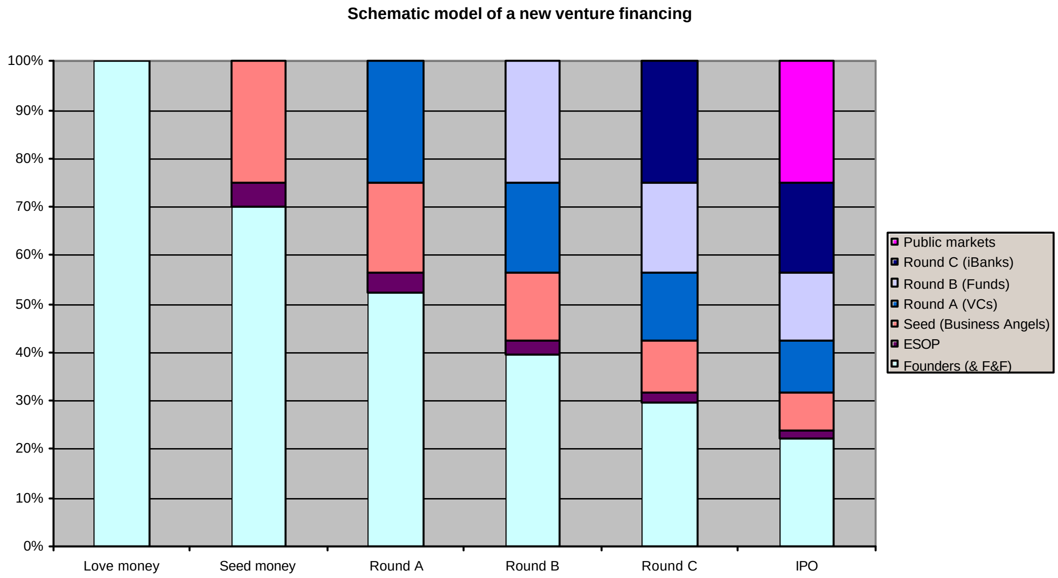
The European market was emerging and less sophisticated than its US counterpart

At the same time, while the US market had developed into a mature market (financial engineering and legal clauses had by now been standardized), US VCs entering the European markets decided to be more lenient on their clauses for Europe.

Indeed, European VCs did not have the same sophistication than US counterparts, and did not develop stringent term sheets, in order to sit at the table of negotiations more often than not. This is particular true, since they had seen fewer failures than US counterparts and had fewer incentives to impose downside protection clauses (double dip, full ratchet, etc.).

Finally, European CEOs were also discovering the money-raising market: those who had been exposed to the US model were more prepared to negotiate better agreements for themselves, whereas inexperienced CEOs did not know the tricks of the trade and did not fully understand the impact of the down-side protection clauses, for instance being completely wiped-out in the case of a downturn by a full ratchet clause.

Monitoring - The application of contracts



Source: the authors

We saw earlier that a significant part of Entrepreneurs loose control of their enterprise between round A and round B. In this section we shall try to show that reality is often not as simple as this chart suggests. Smaller chunks of equity can have stronger influence than the pro-rata of voting rights it represents (this applies to both Entrepreneurs and VCs). We can hint from this chart that conflicts may arise both:

- between investors and founders/management
- between investors themselves;

Additionally many VCs have confirmed to us that they use the contract negotiation period to have a better assessment of the people they are dealing with. Most of them forget about the contracts for everyday management, and only use it as a last resort tool to take control of the company if the situation gets bad. We shall address this issue specifically in the last chapter of this section.

Board of Directors internal fights

When asked about their worst horror stories, most of our interviewees reported that issues arose most often between the VCs sitting on the same Board of Directors, rather than between VCs and the CEO.

- [redacted], an entrepreneur from Brazil, tells us how he went directly for the large private equity capital markets. He intended to create the largest tower management company, by buying portfolios of property from several regional players and leasing them back to mobile operators to install their transmitters. After a long term-sheet negotiation, both the lead PE firm and the founding team had reached an agreement. However because of the size of the round A deal ($100m), the deal had to be syndicated between several PE players. Additionally it made a perfect business sense to have also the largest US player in this industry invest in the venture. Unfortunately, the original investor in the US player ([redacted]) was more risk-adverse than the lead investor for the Brazilian venture ([redacted]). At a final meeting in Pittsburgh, the two VC representatives decided they could and would not work together and the deal was cancelled.

- On another account, after a tactic operational mistake by the CEO, one of the round B investors decided to fire the CEO. The original lead round A ([redacted]) disagreed, for he believed the CEO was able not only to make up for that mistake but also to lead the company forward. Finally because of the preference rights of the round B investor (the last investor in has usually the right to liquidate first), the round A investor wrote off the deal in this portfolio and resigned from the Board of Directors. The CEO was fired. He is currently running a successful publicly traded company, and is still maintaining an excellent relationship with the round A investor ([redacted]). However, the other venture went bankrupt in early 2002!

Finally, most VCs we talked to confirmed they liked to syndicate their investments between several investors, in order both to reduce risk by portfolio diversification, but also to leverage the network of contacts and expertise of the other investing partners. It has proven very effective when VCs' interests are aligned (indeed some of them even run Investor Meetings in preparation of Board of Director Meetings), but can lead to huge conflicts of interest between the parties.

- "The challenge is the dynamic between the VCs and [redacted]: things are often not so black and white.
  It is true that at one extreme, and as an exception to our usual modus operandi of investing with VCs, we do make some investments as a sole investor, where we have found it too difficult to convince VCs as to the benefit of the proposed investment. This may mean that we help grow the company to a stage where VCs eventually see the financial rationale for the investment […] Alternatively, the VC may not fully understand the technology (not that uncommon in some of the real bleeding edge deals) and they may draw sufficient confidence on the technology side to be prepared to invest, together with [redacted]" – [redacted], [redacted] (in a chat with the VOBM elective MBA participants, 18/2/02)

- A german VC with [redacted] adds: "we never take more than 49% unless it is with money form an additionally advised fund."

Balance of power between shareholders (VCs) and management (CEO)

Several interviewees mentioned that there is a big difference between a heavyweight CEO with industry credibility, a strong contacts network and an excellent track history either with industry of with building companies, and with a young and inexperienced CEO (once described by a VC, like a young McKinsey & Co consulting from some office in Holland):

- A Harvard Business Review article from the November/December 1998 issue (p.132) argues among other criteria what "from the VC's perspective, the ideal entrepreneur" should be:
  - "Tells a compelling story and is presentable to outside investors,
  - Recognizes the need for speed to an IPO for liquidity,

- Has a good reputation and can provide references that show competence and skill,
- Understands the need for a team with a variety of skills and terfeore sees why equity has to be allocated to other people,
- Gets along with the investor group,
- Understands the cost of capital and typical deal structures and is not offended byt hem,
- **Is sought after by many VCs.**"

The CEO can be the show master…

On the one hand, the experienced CEO is able to attract a lot of attention from both industry players and serious venture capitalists. Many interviewees experienced sour relationships with this kind of entrepreneur. Being successful, these CEOs had all VCs dancing along in front of them, trying to get a share of the pie. This was more of an over-supply of capital market.

- [redacted], formerly a VC with [redacted] in London recalls a seasoned CEO from the Media industry who managed to fragment his VC base, with no one player having more than 15% of the equity post-money. Hence the CEO would not only build a base of shareholders again each other, but also played the round B players against the round A players who had different rights coming from their different share categories.

Additionally, oftentimes, the whole company's <u>valuation</u> relies on the founder, either because he embodies the company and the venture space with his personality, or because he has control on some assets of the company (key people, technology innovation, and so forth.). Hence shareholders could threaten him with firing him, but to no avail because the CEO knows that the VCs would loose more by doing this than what the CEO would loose.

- On one particular anecdote, [redacted], a VC in Israel, told us that he was unable to sell the company to another interested party, because the CEO refused to give up control of his company and of his dream of building a great product and bringing it to market himself. Indeed, the VC needed the CEO to commit to the new investor in a public appearance before the deal could be signed. The CEO refused to do that, and the deal was cancelled.

… but it usually was the VCs who were in control.

On the other hand, inexperienced CEOs were very keen to find capital, and had usually no track record to support their business idea. This was more of an over-demand capital market. Almost as an industry norm, the VCs replaced the founding team early on before the next round with more grey-haired individuals. Sometimes VCs took over the control of the company, but most often, they tried to run the business undercovered influencing day-to-day decisions. In [redacted] words, "it seems VCs are frustrated entrepreneurs who were looking for a revenge".

- On one count, "a startup in the food business ([redacted]) run into a huge conflict of interest with its VC ([redacted]). [redacted] needed badly to conserve cash burn, and was looking at cheaper options for infrastructure, whereas [redacted] wanted a gold plated approach (ie. Buying Oracle licenses, developing ultra-secure warehousing, etc.). [redacted] wanted to wind up with cash in hand to pay for employees, for debt, etc. but was still in negotiations for further funding which required [redacted] to put in a further round with two other parties. [redacted] kept [redacted] going along because it was in their interest they were also looking for further fund. [redacted] went bust one week before [redacted] did." [interview with [redacted]]

- On another count, [redacted] a Director and Investor with [redacted], a messaging service for the Internet in Israel recalls: "the VCs invested $9m, and were prepared to pay a much higher price, but demanded a bigger say. Their intervention was disastrous: they imposed a general manager above the founders who turned out to be a crook (ousted nine months later at a great cost), demanded certain geographical coverage which proved wrong, promised contacts, etc. but did not deliver. They caused a great deal of harm and waste of resources." "the VCs concentrated efforts for the control of the wrong points (lots of financial reporting and fighting about warrants, etc.) & did not deliver on their promise to help in business development which was the crucial part"

Indeed VCs get very much involved in early stage ventures:

- [redacted] confirms: "The board members elected by the VC sometimes participate in sales meetings with existing customers or prospects."

On several counts, because of either the downside or of an issue with the current management, the VCs did not hesitate to alienate the CEO and wipe him out of the equity structure by applying some protection clauses. Even the threat of doing this was sufficient to impose decisions on the management, even though the VCs had a minority stake in the firm.

Several investors confirmed that running the company however, as interim top management, seems definitively to be a crisis situation (CEO and/or other top management had to be fired). This is not what a VC wants to do, since it is not on the one hand his skills set, and on the other hand, takes time away from the usual financing activity of other deals.

What is the role of a Board of Directors?

Most VCs believe seriously in the strong role of the **Board of Directors**, because it imposes a discipline for young companies to operate as a larger firm in a professional manner.

Unfortunately, as to be expected, most decisions are prepared in advance, and the Board more often than not operated just as a rubberstamp, therefore adding little value. Hence most discussions happen before hand, usually between the lead VC and the executive committee. From our research, most Board of Directors meet very often at the early stage of a company (every week), and then at a slower pace when the company grows (monthly).

Other governance structures include, but are not limited to:

- **Advisory board**: usually include friends with industry knowledge or some industry "big names" used for impressing VCs when raising money; this board usually meets twice a year for advice. One respondent mentioned using this tool as a "reality check".

- **Supervisory board**: this Board is compulsory in some countries, depending on the legal structure of the company (e.g. Société Anonyme à Conseil de Surveillance in France). It has the benefit of clearly separating the role of shareholders with the role of managers. In most cases, however, the Board of Directors has this role. Frequency of meetings is quarterly, with a role of company policy and results supervision.
- **Executive Committee**: a subset of the Board of Directors, includes the top executives for fast decision-making, also sometimes called the "leadership team" including the heads of key silos of business.

The Board of Directors as the effective vehicle for corporate governance?

- [redacted] comments: "we believe, assuming the company has some modest scale (even 10 employees) that we should operate trough the Board of Directors. This discipline encourages building effective Boards as a separate asset for the company. The role on the Board can be either Chairman or simply a Director. If the Boards are too large, we often set up an Executive Committee, meaning a subset of key members. This expedites decision-making. We always have Board Committees to focus on obvious areas (Compensation, Audit and, in some cases, Governance). If there is an investor syndicate, we sometimes have investor syndicate meetings to formalize our approach to the company and/or align our interests as investors. If there are multiple rounds of investment, investors at different levels, of course, have dramatically different objectives, and these must be aligned."
  "Over the years, I have come to deeply believe in the critical role a Board plays. Even with excellent and experienced management, a tight and active Board is an essential element of success. While the Board can simply duplicate management decision-making, I also believe it has to be prepared to understand the business from the ground up, including operating details. Perhaps the most difficult is to periodically and selectively delve into extreme detail while retaining a strategic perspective"

- However, [redacted], a partner with [redacted] in Hungary, challenges this approach: "smaller is the company, less effective is a Board as a forum to make executive decisions. This forum requires certain presentation and formal structures that are hard and expensive to provide in a small start-up."
  "we aimed to take and took non-executive board positions in every start-up investment we made".

- [redacted] agrees: "In a small start-up such as [redacted] (6-10 people), we don't really need any decision making "institutions" as such. The board acts as an official medium to conduct any matters concerning the equity of the firm and to ensure that the VC's interests are always respected in these matters. Decisions regarding the management of the company are all made on an informal basis."

The common view seems to be that the Board acts as a rubberstamp vehicle

- [redacted] of [redacted] Ltd: "it is important to have the discipline of structure of a monthly meeting, but the 2 execs really do all the work / discussion before hand, and the Board reviews and generally confirms without amendment. Our Boards has been very supportive and never gone against the exec's wishes, although probably we have been careful to propose only what we knew would be acceptable".

- [redacted] adds: "BoD meetings took time to develop into the right formal and content focus. Then they worked reasonably well. Preparation was essential (every board member was distributed blue print for required decisions 2 days before the meeting, which were discussed in the BoD". "Usually the department heads were able to get the decisions they wanted, unless they were badly prepared".

- [redacted] concludes: "I think the Board played a couple of roles with regard to decision-making. They kept us honest – so to speak – requiring us (the founders / management) to really think through all our propositions, and they provided some good advice. We essentially made all decisions and went to the board with huge issues such as funding. The advisory board turned out to be quite useless as time passed. We initially wanted their names to beef up out business plan especially when shopping for cash, but in reality we used them very little and don't think it was worth the equity spent"

Hence, nowadays, VCs prefer a hands-off approach

Most our interviews stresses the importance of the Board of Directors for an effective representation of the shareholders' interests. However we noticed a very strong trend of VCs to shift from an active Board seat role towards a non-executive Board seat or even an observer role. Indeed, there is an increased understanding of the liabilities incurred as an investor, and VCs now want to avoid that.

- "Independence issues: this is a valid concern. [redacted] would be concerned about consolidation of accounts - generally viewed as needing attention once you reach 13% fully diluted ownership and most definitely a factor when you hit 20%. Any influence over the company (dependent on the technology space) may well also attract anti-trust/competition law issues. Equally, if a company is perceived as being part of Intel it may well cut off opportunities with potential customers/fellow travellers."
  "[redacted] is acutely aware of attracting liability - it is the reason why its engagement as a shareholder is limited. However, this is contrasted with its significant activity in commercial arrangements with the company. There seems to be some confusion as to the need to be active as a Board Member in order to have an active engagement - many VCs are now taking a role as an observer to the Board rather than taking a seat as a director for exactly these reasons." – [redacted], [redacted] [in a chat with MBA participants, 18/02/02]

- [redacted]: "Our business model is to be passive investors. We do not take board seats, though we are active observers. We expect our co-investors to provide supervision, attract talent, and do what board should do. We've been somewhat frustrated when co-investors do not see their mission as building companies". [Anderson 2002]

- "Intel seeks to avoid liability by not being an active investor:
  - with a strong balance sheet, Intel would be an attractive target for litigation from disgruntled creditors/companies/employees/shareholders if things did not turn out well and Intel had been active in the management of the company; and
  - with such a strong position in key market segments, active participation in too many other companies may be seen as anti-competitive behaviour.

[redacted] success requires [redacted] to be more sophisticated in its approach." – [redacted], [redacted] [in a chat with MBA participants, 14/02/02]

- [redacted] confirms: "Venture capital investors in North America are typically carefully structured to ensure the investors of not have an obligation to the companies as investors. The obligations are simply those of directors (which are fiduciary obligations under the statutes and the law)."

- [redacted] of [redacted] in Germany comments: "Germany supervisory boards serve primarily their own pockets, are deeply un-entrepreneurial, conservative and rarely a guiding light. [redacted] does not take board seats but chooses one board member who has to represent [redacted] interests. This can work quite well.
  [redacted]'s influence comes through our 'passive observer role' in these board meetings, but I try and stir as much trouble as possible, and get things going in the right direction. The UK market is far more mature, sophisticated and does not have these issues."

Firing the CEO become a very common management tool

Although most provisions in the contracts allows the Board of Directors to fire the CEO, in practice it proves difficult for a variety of reasons, including liabilities for the investor. Additionally, VCs openly express the feeling that a founding CEO does not have the skill set to grow a company to a more mature stage, and they therefore have almost systematically have to replace the CEO with another person.

- We asked [redacted] from [redacted], his point of view on these legal provisions: "You are correct to note that there are many protective provisions which are used by [redacted] (and all other investors) when investing in companies today (as opposed to two years ago where these protections were weaker).
  However, they rarely put any one shareholder in the driving seat such that they could be managing the company in the event of a disagreement with them management of the Company - the corporate veil between shareholders and management would not be pierced by [redacted] - the reason: liability. If you are a manager/executive director you have duties to your shareholders/employees/creditors and [redacted] would not wish to get involved with these duties (and the potential liabilities that go with them).
  In practise, these protections are cumbersome and difficult to enforce - eg even in situations where the shareholders generally agree that the CEO could do a lot better, it takes quite some time in practice to replace them.
  Conclusion: [redacted] never achieves effective management of the portco."

- [redacted] adds: "while aiming for minority, we usually include a control flip-over right into our documentation. We had to exercise this right twice over a 10 year period. In one case it saved the company from bankruptcy and the investment provided nice returns after a year of restructuring, in the other case it was not successful;"

- [redacted] comments: "in quite a few cases, we have invested in very early stage companies. This ahs required both replacing founders/CEOs and removing founders from our companies. I and my partners have filled many roles in the companies, but the prime roles would be CEO and CFO. We also have an Entrepreneur in Residence who can assist with sales, marketing and positioning".

- [redacted], a partner with [redacted], a seed stage technology VC in Israel and US confirms: "we avoid running companies. We have had several times the need to fire the CEO, but replaced him/her immediately. We have very rarely run a company as members of an executive committee. This is highly undesirable temporary means of crisis management."

Evidence on incentives

Apart from the threat of firing top management, we concluded that Board-level involvement was not the right way to control the agency problems between investors and management. We then explored other mechanisms such as the incentives schemes.

Most companies we talked to use some combination of the following incentive mechanisms:

- **Base salary**: usually defined in order to support living expenses
- **Variable salary**: the range can be between 0 and 100% of the base salary, usually settling at approximately 40%. It is usually used as an operative incentive.
- **Stock options**. A definite focus to attract talent, mostly symbolic and only worth something in the case of an exit. They tend to have a long-term upside to drive commitment for it gives people a piece of the company they are building.
- **Bonuses**: Used as an achievement of certain milestones.
- **Other benefits** such as pension retirement schemes (401(k) in the US), dividends from equity, etc.

Compensation for venture-backed software companies
Source: Helen Wong & Advanced HR

Austin — **Median Numbers**

	salary	ownership	bonus	total target comp
CEO	170	4,4%	117	200
VP Eng	153,5	1,4%	20,5	168,5
CMO/VP Mktg	157,5	0,7%	30	187,5
CFO	150	0,7%	35	150
CTO	130	1,1%	37	130

SF Bay Area — **Median Numbers**

	salary	ownership	bonus	total target comp
CEO	200	6,4%	75	234
VP Eng	175	1,2%	50	209
CMO/VP Mktg	160	0,9%	47	185
CFO	154,39	0,9%	40	171
CTO	180	1,4%	35	225

75th Percentile Numbers

	salary	ownership	bonus	total target comp
CEO	250	6,6%	100	331
VP Eng	200	1,9%	69	240
CMO/VP Mktg	180	1,3%	60	231
CFO	167,5	1,1%	46,5	203
CTO	200	1,7%	60	240

Dallas — **Median Numbers**

	salary	ownership	bonus	total target comp
CEO	118	3,9%	50	118

- [redacted] comments: "Incentives depend on the level of the employees with the and the area they work in. Typically, non-sales employees receive a variable salary of up to 25% of their base. They also receive stock option bonuses. Sales staff may receive 50% to 75% of their compensation in the form of performance bonuses. The CEO (if he is not a founder) has options for 3% to 7% of the company and receives 50% of his compensation based on performance. The CFO receives 1% to 3% in options and has 25% of this compensation based on performance. The Vice President, Sales holds 1% to 3% in options, and has 50% of his compensation based on performance. Other Vice Presidents hold 0.5% to 2% in options and have 25% to 50% of their compensation based on performance.
  Properly structured, these incentives are essential. However it is critical to structure them carefully, because they <u>do</u> change performance."

How effective was salary (fixed and variable)?

- [redacted] offers an interesting approach: "we intentionally underpaid people to work for us. We found what their current salaries were at the time of interview and offered them on average 5-10% less. This practice guaranteed that people we were hiring were signing on to be part of the special culture and organization we were building. Some people eventually left to go work for a dotcom for greed reasons. Most stayed with us. Those who did were financially rewarded at the time of our acquisition by [redacted]."

- [redacted] comments: "the variable part is between 20% and 40% of the base salary. Both the variable part and base salary are decided every 6 months. Everyone can feel the difference.
  Half of the variable salary is based on team results killing selfishness of individuals and stressing no team oriented behavior".

- [redacted] reflects back: "I think we implemented an incentive plan for the sales team this year. […] I think this is one of our weakest areas and that we need to make more use of incentives to motivate our team."

How effective were bonuses?

- [redacted] comments: "we find that bonuses driven by pre-set goals are not very effective because of the frequency with which the goals change during the year, and because of the interdependence between the carious departments' ability to meet their goals, e.g. sales can't deliver if R&D doesn't, and R&D can't deliver if marketing / product management doesn't. This is truer the more senior the executive in question, and the earlier the stage of the company. Therefore in early stage bonus formulae tend to be complex and in the end the board decided on the bonuses subjectively."

- [redacted] adds: "Milestones are rarely met, probably in 3% of the cases"

- [redacted] did not use them: "we avoided things like sales commissions or individualized bonuses because of the tendency of such systems in creating cultures of entitlement (skew employee motives) and stratification. We had profit-sharing, but it was applied evenly as a cross-firm percentage of people's salaries. That percentage fluctuated annually based on overall company performance. It was a low as approximately 10% and as high one year, as 40%"

How effective was equity?

- [redacted], CEO [redacted].com: "motivating people by involving them in the capital was the most simple manner from the very beginning"

- [redacted], Managing Director of [redacted] Ltd. agrees: "a small business, senior management incentivised by ownership".

- [redacted] offers a more nuanced view: "equity / options are very effective as long as people believe in a substantial future value of the company (>500 Mil).
  This is conceivable in our industry (financial services broker) but not in many 'new economy' type start-ups, in my opinion, and I think equity would be less effective in these other types of companies".

How effective were stock options?

- [redacted], co-founder [redacted] Ltd: "I don't think the share options make any difference to employee motivation really because in an unquoted company they are

meaningless. Of course if wed got near to a float / trade sale they would become more of a focus".
"I also don't think the level of options makes any difference to how hard we execs work"

- [redacted] comments: "options proved to be the most effective incentive from the investor point of view. For these to work, the management team members' compensation package and/or existing net worth has to provide full cover for the living expenses of the individual, otherwise a future high risk cash-flow cannot balance actual prompt cash need."

Conclusion - Recommendation

A minute understanding of each party's motivation is crucial

From our research, we think that partners entering a deal should have a very clear understanding of the motivations of the other party before signing a contract.

Indeed, it might be just fine if greed drives both the VC and the Entrepreneur. The venture would be grown very fast, in order to prepare for an IPO as an exit vehicle. Both parties would benefit, to the expense of the other parties and stakeholders such as minority shareholders, employees, clients, suppliers, etc. Although we did not specifically research this aspect, the Nouveau Marché in France show many examples of such a hasty public offering for startups (Cyrano, Multimania, etc.), which now trade in the single digits.

We also talked to entrepreneurs and VCs who ink a deal for the long-term. Their relationship is usually built on trust and they draw on the resources of each other to grow the venture.

More agency costs therefore arise when investors (usually with a short-term focus) and entrepreneurs (usually trying to fulfill a builder's ego in the long term – private benefits in the theory jargon – or trying to profit from the situation in the short-term) do not understand each other.

We hence recommend a stronger emphasis on performing solid due diligence on the individuals from both sides, more than focusing on the business plan issues.

A fair approach to contract negotiation

A lot of interviewees highlighted the aspect of trust and mentioned that the contract became just a formality that they would not care about after signing it. Importantly, initial clauses may have an important role in shaping trust.[4]

It seems to us that a large amount of time is wasted re-discussing the obvious (90% of clauses are standard), because Entrepreneurs feel that VCs are more than willing to share the upside of the venture, and over-protecting themselves from a downside.

We think different ways of sharing this risk may be developed spontaneously by the investor community in their relationship with the entrepreneurs, offering him equal power in the development of the venture. Of course this would depend on the relative competitive environment, in terms of the availability of entrepreneurs and VCs in the market.

Corporate structure for an efficient Monitoring

Random or excessive involvement affects greatly the morale of top management who bear the pressure of micro-management by their VCs.

However, on the one hand, there are the incentives for VCs to get involved because they are trying to maximize their investments, but on the other hand these involvements have costs in

[4] "The Framing of perceptions of Fairness in the Relationship between VCs and New venture Teams", Busenitz et al. 1997

terms of time and information gathering. These means that VCs also do not want to get too much involved.

We believe that VCs should define before hand with management the level of involvement they wish to have with the company during normal operations. They should also define their level of involvement for several types of crises, instead of just having clauses that allow them to fire the top management.

Finally, we believe that two incentive structures for top management should be developed:

- In the case of a founding CEO, the alignment of goals is key. No other financial incentive should matter for he retains a substantial and fair amount of equity (if the negotiation was fair) and will be entitled to the upside.

- The issue has more to do with CEOs hired outside the firm, and for other non-founding top management. Their package should cover the opportunity cost for them to work elsewhere (base salary), and include an option to share the upside of the company (stock options, profit-sharing, bonuses).

- The purpose of such incentive components should be discussed thoroughly with the concerned individuals and by no means be given away by the company as a standard industry package.

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APPENDICES

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List of interviews / questionnaires

We wish to thank all the following individuals who took time to either talk with us or to fill-in a detailed questionnaires. We also would like to thank all the other people not mentioned here but who agreed to a telephone interviews for which, unfortunately, we did not have time for.

Entrepreneurs

Contact name	Position	Description	Company	country
[redacted]	CEO	Internet strategy, design and technology consultancy (sold to [redacted] Corp)	[redacted]	USA
[redacted]	Co-founder	Infrastructure-based, ICT outsourcing service provider to medium-large companies	[redacted]	Italy
[redacted]	CEO	Codename for launch of new online bank for SME's	[redacted]	UK
[redacted]	President	Messaging service communicating internet with phones, SMS, etc.	[redacted]	Israel
[redacted]	Founder and CEO	Online C2C auction site	[redacted]	France
[redacted]	Founder, CEO	Outsourced interim contract management	[redacted]	France
[redacted]	Director, co-owner	Virtual tours service provider	[redacted]	UK
[redacted]	Co-founder	Internet-based communication technology company providing medical research services to pharmaceutical / biotech sector	[redacted]	USA
[redacted]	CEO, co-founder	Billing / e-billing ASP (liquidated)	[redacted]	France
[redacted]	CEO	Electronic Trading paltform for derivatives	[redacted]	UK
[redacted]	CEO	Mobile Virtual Network Operator	[redacted]	France
[redacted]	VP Marketing	Efficient onlien and mobile payments	[redacted]	NL
[redacted]	Founder, CEO	Group buying (sold to dealpartners.com)	[redacted]	France
[redacted]	CEO	Drug delivery startup	[redacted]	France
[redacted]	Managing Director	Acts as director and corporate services provider to special purposes companies used in securitisations & structured financing	[redacted]	UK
[redacted]	VP Business Dev.	Value and Supply Chain software	[redacted]	USA
[redacted]	Co-founder	Tower mangement company for mobile operators	[redacted]	Brazil
[redacted]	Managing Director	Quality of service and Optimum Routing Software for Telecoms Carriers	[redacted]	UK
[redacted]	Founder, CEO, Board member	Internet incubator with investments in 16 internet startups (B2B, B2C, NIEM, infrastructure)	[redacted]	Brazil
[redacted]		Food delivery startup	[redacted]	
[redacted]	Founder, Board member	Home automation	[redacted]	

Venture Capital / Private Equity professionals

Contact name	Position	Description	Company	country
[redacted]	Investment manager	Support services PE	[redacted]	London
[redacted]	Former VC		[redacted]	Australia
[redacted]	Analyst	Fund management through PE investments	[redacted]	Spain
[redacted]	General partner	VC in High-Tech and Life Sciences	[redacted]	France
[redacted]	Gérant	Holding and management company for industrial investments	[redacted]	France
[redacted]	Co-founder	VC for early-stage IT companies	[redacted]	Switzerland
[redacted]		VC	[redacted]	UK
[redacted]	VC	Comment on a wireless software portfolio company	[redacted]	
[redacted]	VC		[redacted]	Israel
[redacted]	General partner	VC	[redacted]	Israel
[redacted]	Former M&A Director	Equant Corporate Ventures	[redacted]	Holland
[redacted]	Manager		[redacted]	UK
[redacted]	Associate	VC	[redacted]	Menlo Park, CA, USA
[redacted]	Investment manager	Investment company, LBO	[redacted]	France
[redacted]	Health care team		[redacted]	UK
[redacted]	Managing Partner	VC investor	[redacted]	Canada
[redacted]	Founder	Management of tech VC fund in Europe	[redacted]	Switzerland
[redacted]	Associate	Corporate venture capital	[redacted]	USA
[redacted]	Director	VC and PE	[redacted]	Hungary
[redacted]	Partner	Sees stage technology VC in Israel and southeastern US	[redacted]	Israel
[redacted]	Investment manager in healthcare and biotech	[redacted] VC	[redacted]	Germany

Lawyers

Contact name	Position	Description	Company	country
[redacted]	Lawyer	High-Tech law firm	[redacted]	France
[redacted]	Assistant Solicitor	M&A	[redacted]	UK

Glossary

Note: This glossary was compiled using the definitions provided by NASDAQ on http://www.nasdaqeurope.com/quotes/help/glossary.asp

Business Angel

A person or entity that provides financing to companies that have progressed beyond the start-up phase but are not yet ready for venture financing.

Anti-Dilution Provisions

Provisions in an option or a convertible security (such as convertible preferred stock, which is the typical form of venture capital or mezzanine investment) which protect the holder's investment from dilution as the result of later issues of stock at a lower price than the investor paid by adjusting the option price or conversion ratio. *See 'Anti-Dilution, Full Ratchet' and 'Anti-Dilution, Weighted Average'.*

Anti-Dilution, Full Ratchet

Anti-dilution provisions that apply the lowest sale price for any shares of common stock (or equivalents) sold by the company after the issuing of an option or convertible security as being the adjusted option price or conversion ratio for existing shareholders. As an example, if a prior round of financing raised capital at $2.00 per share with investors receiving full ratchet anti-dilution protection, and a subsequent round of financing was consummated at $1.00 per share, the early round investors would have the right to convert their shares at the $1.00 price, thereby doubling the number of shares they would receive. *See 'Anti-Dilution Provisions' and 'Anti-Dilution, Weighted Average'.*

Anti-Dilution, Weighted Average

Anti-dilution provisions that apply a weighted average formula to adjust the option price or conversion ratio of an early-round investor, based on the sale price and number of common equivalent shares sold by the company after the issuing of the option or convertible security. As an example, if a first round of financing raised $1million of capital at $2.00 per share and the first round investors received weighted average anti-dilution protection, and a second round of financing was consummated for another $1million at $1.00 per share, then the first round investors would have the right to convert their shares at a weighted average adjusted price of $1.50 per share. *See 'Anti-Dilution Provisions' and 'Anti-Dilution, Full Ratchet'.*

Bridge Loan, Bridge Finance or Bridge Round

A loan, or equity investment to provide financing for a relatively short time period until the issuer can complete a longer term financing such as a public offering.

Covenants

In the venture capital context, an agreement by the company, which may remain in effect as long as the venture capital investors hold a stated amount of securities or may terminate on the occurrence of certain events (eg completion of a public offering). Affirmative covenants define acts which the company must perform, and may include payment of taxes, maintenance of corporate existence, insurance, property and equipment, environmental and legal compliance, representation of venture capital firm on the board, etc. Negative covenants define acts which the company may not perform, and could include a prohibition on mergers, sale or purchase of assets, amendments to its corporate charter, incurring of indebtedness, the issuing of securities, distributions and redemption of securities, etc.

Drag Along Rights

The right of controlling shareholders to force other shareholders to join in the sale of a company.

Due Diligence

An examination of the books and records of an issuer and interviews with officers, partners, etc, to confirm information about the issuer's business as well as legal and accounting affairs. It typically includes a review of such matters as significant customers and suppliers; the background of key employees (to learn of prior employment problems, criminal convictions, disciplinary actions by market regulators, fraudulent resumés); material contracts; facilities; real property owned; subsidiaries; judgements and lawsuits; insurance; patents and other intellectual property rights; licenses and permits; and tax status. The phrase derives from the fact that certain persons (including the directors, underwriters and auditors) are personally liable for a misstatement of material fact in a registration statement unless they can demonstrate that after reasonable investigation they had reasonable ground to believe, and in fact did believe, that the statement was true.

Follow-On Investment

An additional investment by existing investors, which may be provided for in documentation relating to the initial investment.

Golden Handcuffs

A method of insuring that key employees remain with the company for a certain period of time by granting the employees options or restricted shares of stock that vest over a period of time.

Golden Parachute

Usually a contractual arrangement between key employees and the company, that provides for the payment of a large bonus or other payment to the employee upon the occurrence of certain events, such as termination of employment without cause, or the merger or sale of the company.

Incentive Stock Options or ISOs (USA)
Stock options available only to full time employees that are entitled to special tax treatment under the US Internal Revenue Code. The employee who exercises the option does not have to pay tax until the employee actually sells the stock. However, the employee may be subject to US Alternative Minimum Tax. The company does not get a tax deduction. *See 'Non-Qualified Stock Options' and 'Combination Stock Option Plan' for comparison.*

Independent or Outside Director
A member of the Board of Directors who is not an employee of a company nor affiliated with a controlling stockholder of a company. The definition of 'independent' may be further defined in different countries or markets.

Information Rights
The contractual right to obtain information about a company, attend board meetings, etc. Typically received by venture capitalists investing in privately held companies.

Mezzanine Financing or Round
A financing round in venture capital-backed companies occurring after the company has completed its product development and after it is an operating company, but before the company is ready for a public offering or to be acquired.

Pre-emptive Right
The right of an investor to participate in a financing to the extent necessary to ensure that its percentage ownership of the company's securities will remain the same before and after the financing.

Preferred Stock
Stock which has a 'preference' over common stock, including priority in receipt of dividends and upon liquidation. In some cases it also has redemption rights, preferential voting rights, and rights of conversion into common stock. Venture capitalists generally insist upon receiving convertible preferred stock.

Redemption
Repurchase by a company of its securities from an investor. Often required for preferred stock in a venture capital financing.

Right of First Refusal
A contractual right, frequently granted to venture capitalists, to purchase shares held by other shareholders before such shares may be sold to a third party.

Staggered Board of Directors
A board of directors divided into classes (typically three) elected for multiple year terms, with classes coming up for re-election on a staggered basis. A staggered board may be used as a form of anti-take-over device. *See 'Anti-Take-over Provisions', 'Blank Cheque Preferred Stock', 'Poison Pill' and 'Shark Repellent'.*

Stockholder Agreement
An agreement among stockholders, typically in a private company and in the context of a venture capital investment, to ensure maintenance of stable ownership and management of a company for the life of an investment. This may include, among other things, a right of first refusal in favour of the issuer or other stockholders on a proposed sale by a stockholder of his or her stock; a right to participate in insider sales (ie sales by existing shareholders); an agreement to elect certain directors; and provisions as to buyout.

Tag Along Agreement
(also called Co-Sale or Take Along Right)
A contractual agreement by management stockholders typically in connection with a venture capital investment, that they will not sell any of their stock in the company without giving the investors the right to participate in the sale pro-rata to their holdings.

Term Sheet
A short document summarising the principal financial and other terms of a proposed investment. It usually is non-binding, but may impose some legal obligations on the investor and the company.

Venture Capitalist
An individual or entity that specialises in providing venture capital financing.

Vesting (Stock, Options and Warrants)
Over a period of time an employee of a company earns rights to receive benefits (eg stock) as a result of that employment, though until such rights are earned the employee can claim no ownership of the related benefits and those potential benefits are forfeit. Restricted stock or options, or warrants to purchase stock, that may not be sold or exercised, or that are subject to risk of forfeiture, for a period of time, are 'unvested'. That portion of the stock which is not subject to risk of forfeiture and which may be sold, or the options and warrants that may be exercised, are referred to as 'vested'.

Sample term sheet

[sample term sheet not included in this version, as it is the intellectual property of its authors]