

VENTURE CAPITAL 101 FOR OWNER MANAGERS: UNDERSTANDING VENTURE CAPITAL AND STRUCTURING VENTURE CAPITAL DEALS

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Although it has been around for decades, venture capital gained incredible visibility among owner managers during the 1990s. Unfortunately many people failed to fully understand what venture capital was all about, while many venture capitalists lost sight of business fundamentals and made a lot of questionable investments. The combined effect was to change “venture” capital into “vulture” capital in the perception of many owner managers. However, venture capital is rebounding. The purpose of this article is to give owner managers an understanding what venture capital means to them so that they can better understand if, when and how it could be right for them.

Introduction: The “Me First” Principle

If there is one thing I want owner managers to keep in mind about venture capitalists, it is this:

VCs insist on getting their money out before you do.

This manifests itself in a number of ways:

- VCs value the money they are putting in today much higher than the money you have already put in or left in.
- VCs want their money to rank in priority to the money you already have into your company.
- VCs want to make sure they hit their return on investment targets before you get return on your investment.
- VCs do not want you taking money out for yourself before they get their money back.
- VCs want a significant role in directing the company, and require a high degree deal of accountability, so that they can monitor their investment and influence how things turn out.
- VCs want a significant say in when and how they get their liquidity, and the option of taking action to get their money back as and when the circumstances best suit their requirements.
- VCs want the option to get their money back as debt or equity, depending on how things go and what gives them the best return on investment.

- VCs want the option of kicking you out and taking over your company if things do not go well.

Compounding this issue is the returns VCs are looking for. They are looking, in their overall portfolio, to beat the public equity markets. Since venture capital by its very nature will produce a number of investments that will fail to perform at all, the winners they get have to win big.

Finally, VCs are usually short-term investors. They are looking for a liquidity event within three to seven years after making their investment.

The *Me First* principal will be a recurring theme in this article, not as a criticism, but as a simple statement of fact that owner managers thinking of using venture capital must come to grips with. It will be particularly important when looking at some of the things that go into structuring a venture capital deal.

What VCs Are Looking For ...

The first step to understanding venture capital is to consider the meaning of “*venture*”. Here’s the definition in the Compact Oxford English Dictionary (2003):

venture • noun **1** a risky or daring journey or undertaking **2** a business enterprise involving considerable risk.

Venture capital, therefore, is capital made available to a business enterprise involving considerable risk.

Since privately owned, owner managed businesses, are the highest risk businesses out there, they can be fertile soil for venture capitalists.

However, the old adage *the greater the risk, the greater the reward* comes into play. To justify making an investment in such a “venture”, the rewards must in the long run be substantially greater than the returns available for less risky investments, of which shares in publicly traded companies are the most common comparison.

Also, because of the risk level, liquidity becomes more important. Since privately owned companies are risky and not very liquid, venture capitalists are looking for liquidity events in the near future as well as good rates of return.

Therefore, typical venture capitalists are usually:

- Investment companies run by financiers – usually former accountants or stock brokers – who have particularly good knowledge of finance, business and the public equity markets.
- Funded by pension funds, institutional investors or very wealthy private investors looking for superior returns on high risk investments using a portion of their available investment money; willing to fund a venture capital firm for a term of seven to ten years.

- Looking for private companies with significant short-term growth prospects that they will be able to guide into a sale or initial public offering transaction in a three to seven year time frame.
- Hoping to manage a portfolio of investments that, overall, will provide a better return to their investors, after all expenses of running the venture capital firm, than the investors would get from their traditional stockbrokers and public company investments.
- Accept poor performance on a number of investments if they can get an amazing return on some of their investments.

However, venture capitalists would prefer to make money on all their investments. Therefore, typical investment criteria for a venture capitalist will include: ... *strong business fundamentals, a qualified and competent management team, good strategic partners, an excellent market opportunity, key-differentiating factors and demonstrated success* ... (Covington Capital Corporation – www.covingtoncap.com).

Since the liquidity horizon of their own investors is usually around ten years, venture capitalists really emphasize high growth opportunities with a liquidity event in a three to seven year horizon.

... And What It Means For An Owner Manager

If you think you might be the kind of owner manager a venture capitalist is looking for, then you need to consider the *Me First* rule and what you now know about venture capitalists:

A venture capital deal means for sure that you will lose your independence and autonomy, and that you have to be prepared to lose control of your company no matter how things turn out.

At the time a deal is done the VC will insist on ratcheting you down. They will have veto rights over major decisions. They will insist on positive covenants, negative covenants and restrictive covenants. They will take seats on your board and introduce public company style corporate governance. They will insist on audited financial statements. None of these things are negative in and of themselves, and are simply the price of getting access to their capital. However, many owner managers value independence and control, and may come to resent the restrictions imposed upon them if they do not fully appreciate what these restrictions mean to them in advance of closing the deal.

If you succeed in your high growth opportunity, you will need to provide a liquidity event. It can be very difficult to simply “refinance” the company to give your venture capitalist the returns that will be built into the deal. You will probably need to go public or sell the company. In either case, it is likely that your “control” position in the company will be eliminated or drastically reduced. Even an IPO in which you end up with more than 50% of the shares in the company will permanently integrate auditors, independent directors, audit committees, compensation committees, securities regulators, minority shareholders, institutional investors and public accountability into your business.

If you do not succeed in your high growth opportunity, you will not provide the liquidity event the venture capitalist is looking for. They will exercise their *Me First* rights and either force you to sell the business with the lion’s share of the money going to them, or oust you as CEO of your

own company and take over the board of directors and management of the business while they figure out how to maximize their return on investment in priority to you or your legacy shareholders and investors.

Compounding all of this is the need for speed. Venture Capitalists have a fairly short time horizon – three to seven years. Many owner managers want to be in it for the long haul. This could be a conflict that needs to be recognized before the deal is made, as most VC deals are structured so that their schedule supersedes anything else the owner manager may have in mind or want to do.

Making a move to venture capital is a bold play. It takes courage, ambition, a belief in yourself and your business, a desire to make big money off your stake in the business in a short time frame, and acceptance of loss of control as a consequence.

That is exactly the kind of owner manager a typical venture capitalist is looking for. The problem is that those ambitions are easier to say than to execute, even with a big cash investment into your business.

Many owner managers have a strong desire for independence. If your business is going to do very well whether you do a venture capital deal or not, and you are not willing to trade independence for a shot at a home run, then you better be careful about venture capital.

An Introduction to Deal Structure - Where They Fit: VCs Compared To Traditional Lenders

VCs really are equity investors, not simply bankers by another name. However, they often structure their deals as convertible debt or preferred shares to make sure that they can take over the company, or get their money out ahead of the founders and common shareholders, or both, if things do not go as planned. This can lead to some confusion in the mind of an owner manager who thought he was getting an equity partner but gets a lot of legal paperwork that makes his banker's documents look like a grade school essay. Hopefully this chart will help put things in perspective.

The chart focuses on the typical range of institutional lenders. It does not address angel investors, sweat equity deals, employees stock options and other less institutional investment opportunities.

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
What They Lend Against – Tangibles	Lends against historical, accumulated, tangible and liquid assets (e.g.	Lends against historical, accumulated, tangible assets – often not as liquid (e.g.	Looks at everything, but will lend against net book value and retained	Since the growth in equity is what they are after, they invest based on prospects for the

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
	receivables, inventory)	equipment, real estate)	earnings	business as demonstrated by past performance, management capability and market opportunity.
What They Lend Against – Intangibles (Work In Process, Retained Earnings, Goodwill, Future Prospects and Growth)	Values and requires liquidity, but does not specifically lend against covenants and ratios. However, failure to maintain liquidity covenants will trigger a default. Growth is not as important as maintaining covenants.	Values and requires liquidity covenants, but not as much as the operating lender, and does not usually lend against them. Will sometimes lend against retained earnings. Failure to maintain covenants will trigger a default. Growth is not important – maintaining payments and security value is the key.	Will value and lend against work in process and retained earnings, and may lend against goodwill. Failure to maintain covenants will trigger a default. Growth is important, but values security and fixed rate of return more than equity component.	Gives full value to retained earnings and goodwill. Heavily focused on future prospects and growth opportunity. Failure to maintain certain covenants may not automatically trigger a default response. Growth is everything.
Debt Service Capabilities	Very, very important. Cannot borrow without it. Failure to maintain it triggers default.	Important. Cannot borrow without it. However, making the payments on their loan and preserving their security position is more	Important, but can sometimes borrow without it if prospects post-closing are good. Failure to maintain it does not always trigger a default.	Important to maintain the debt service of the secured creditors, but not usually looking for debt service on their investment.

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
		important than anything else.		
Payments and Cash Flow Impact	Mandatory monthly payments, usually of interest only.	Mandatory monthly payments, usually of interest and principal.	Usually require mandatory annual payments – sometimes interest only or sometimes interest and principal – but may be tied to profitability and may accumulate and carry forward if insufficient profits to make the payments.	Payments prior to liquidity or default not usually required. If fixed returns are negotiated, they are often accumulated and carried forward until a later default or liquidity event.
Debt versus Equity	100% debt, usually against all assets of the business as well as the specific assets they are lending against (e.g. receivables, inventory).	100% debt against specific tangible assets.	Mostly debt, with some equity kicker.	Can be debt or equity or both, but usually weighted in favour of equity. Often structured as a convertible debt or convertible preferred share or both so that they can take over the business and get their money out first if things do not go well. However usual preference is to get return off equity. Will use debt or equity

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
				depending on what happens and which way gives them the most return. Equity usually less than a majority but significantly bigger than mezzanine financing.
Priority	First, ahead of everyone, especially on their key assets (e.g. receivables, inventory).	First on specific assets (e.g. land, equipment). Often does not bother with any secondary position.	Usually secured behind operating and term lenders, but ahead of unsecured creditors and definitely ahead of common shareholders.	Will set themselves up ahead of unsecured creditors and common shareholders, but behind other secured lenders, pending a liquidity event that triggers their equity conversion.
Length of Commitment	Usually demand loans, subject to annual review.	Usually for fixed terms – 5, 10 or sometimes 15 years.	Debt portion normally matures within 5 to 7 years, with a put option in favour of the lender on the equity component, meaning lender can choose to stay as a long term minority shareholder after their debt	Usually a 5 to 7 year mandatory liquidity event with emphasis on equity conversion and buyout.

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
			is repaid or can insist on being bought out after the debt is repaid.	
“Interest” Component, Guaranteed Rate of Return	Always interest based – usually floating.	Always interest based – can be floating but often fixed.	Almost always an interest component – usually fixed.	There is often an interest component as a fallback in case the equity side of the deal does not work out as planned, usually as a penalty for management for failing to perform – however, the real goal is to realize on equity.
Risk Assessment	Does not want risk. Considered low risk.	Does not want risk. Considered low risk.	Medium level risk, reflected in higher fixed rates of return and small equity component.	Very high risk, reflected in priority over common shareholders and significant equity opportunity with high cost debt fallback if things do not work out.
Cost of Money	Not expensive. Will accept relatively low rates of return.	Not expensive. Will accept relatively low rates of return.	Debt portion definitely more expensive, and looking for significant rates of return overall by adding in an equity	Will be the most expensive, but the boost in value of the company as a whole, which significantly benefits the

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
			component.	common shareholders, should make the returns to the investor seem fair in the long run.
Management Control	Minimal monthly reporting, and an annual review meeting.	Minimal annual reporting; typically no reviews as long as covenants and payments being maintained.	Board seat at option of lender, quarterly and annual reporting quite common, wants to know what's going on but not really looking to have a say.	Significant board position, with capability to take over the board if things do not go as planned. Likes to provide strategic guidance and have a say in things. Monthly or quarterly board meetings are usually mandatory. Compensation and audit committees with independent board members quite standard. Usually require employment contracts for all senior managers, including board right to terminate if things do not go well. Will readily take over the board if

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
				problems arise, and not afraid to act quickly in that regard.
Patience	Some patience available, likes to work things out.	Will be patient, as long as payments being met and security values holding up.	More patient than a banker, but not afraid to act if real problems develop.	Not particularly patient. Looking for results quickly.
Deal Complexity	Probably the simplest of all. Sometimes done without needing lawyers or accountants. Manageable, but getting more complex each year that goes by. Documentation not negotiable.	Usually more complex than operating loan paperwork, and rarely done without lawyers being involved. Getting more complex each year that goes by. Documentation not very negotiable.	Can seem complex to many owner managers, and cannot be done without lawyers involved. Often good to have an accountant involved as well. A shareholders' agreement is often part of the deal. Usually not much room to negotiate on the debt component, but some flexibility on the other documents, which are not as complex as VC deals.	Very complex to most owner managers and their professional advisors. Definitely requires legal representation. Getting an accountant involved is often a good idea. A number of inter-related and complex documents are involved. Shareholders' agreements are mandatory. VCs are usually quite willing to negotiate terms and terminology in order to get the right deal in place for everyone, provided that their basic rights

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
				and priorities are not messed with.
Ability To Refinance or Replace Them	Usually quite happy to get their money back, whether the company is doing well or not.	Usually fixed term investments. Not in a hurry to get their money back if you are making the payments. Will be open to prepayment in limited circumstances and with a pre-payment penalty.	Not usually in a hurry to get their money back if the company is doing well. Happy to get their money back if the company is not doing well. Generally speaking, are approachable as long as there is a good story to tell and you are willing to give them a fairly decent return on their investment to exit early.	Very difficult to replace after they are in place, whether the company is doing well or not. Difficult and expensive to dislodge. If the company does poorly, they prefer to replace the founder with new management, take over the company, and work it out on their own.
Overall Value to an Owner Manager	Very valuable. All owner-managed companies should take advantage of this kind of financing.	Very valuable. Most owner-managed companies should take advantage of this kind of financing.	Of limited value to most owner managers. Can be very useful in turnaround situations, in management or partner buyouts, in conjunction with a venture capital or other equity investment, or when entering a clear growth	Of value to very few owner managers. Can be very useful in high growth opportunities when the owner manager is building to sell or wants an IPO within five years. But the owner manager must be willing to risk it all, as it either works

Key Factors For An Owner Manager To Consider	Banks Based Operating Loans	Term Loans, Asset Based Lending and other Senior Debt	Mezzanine Financing or Sub-Debt	Venture Capital
			phase.	well or you are out the door and the VC has your company.

Structuring Venture Capital Deals: Concepts and Terminology

No two venture capital deals are exactly the same, and structuring VC deals is an intricate and complex business. A detailed outline of the different possibilities is beyond the scope of this article. However, I can introduce you to some of the basic concepts and terminology.

Many of the techniques discussed below fulfill multiple objectives. That is often where the complexity comes in. However, for the purpose of this article I will arrange things under four broad headings – *Valuation and Investment Issues*; *Liquidation Rights*; *Exit Strategies*; and *Management and Accountability*.

Keep in mind that this is an introduction only. No two deals are identical, and there is lots of room to customize deal structure to the opportunity.

Valuation and Investment Issues

Valuation issues are beyond the scope of this article. However, if you are seriously thinking about doing a venture capital deal, it would be an excellent idea for you to learn how businesses like yours are valued, and maybe even get a professional valuation done for you. It could greatly assist you in your negotiations. I strongly recommend you use a professional business valuator, and not rely upon your accountant, lawyer or other generalist business advisor to prepare you for a valuation negotiation.

Pre-Money Valuation – This is the money value of your business as estimated by your investor before they make their investment.

Post-Money Valuation – This is the value of your business after the investment has been made. It is often simply the pre-money valuation plus the amount of cash invested. However, it could be argued that the post-money valuation is greater than the sum of its parts, as a well-funded business might have more value than the simple addition to its bank account might indicate.

Liquidation Rights

The heading “Liquidation Rights” is a catchall for a number of things, all built around the *Me First* principle. Together they add up to a number of things, including:

- Assurance for the VC that they will get their investment money back before you get any of your investment out of the company;
- Assurance for the VC that they will get their investment money back before you make a profit off their investment in the company;
- Preservation of their position and rights with respect to the company;
- Preservation of their liquidity preference in almost any anticipated scenario; and
- A mechanism for the VC to move in on you and your company if the deal does not work out as planned.

Liquidation Preference – This is an amount of money that must be paid back to the investor before you get to make any money on the deal. It is often the amount of cash invested, plus a return on investment factor (imputed interest). It amounts to a priority over the common shareholders, and has debt-like qualities. The return on investment factor can be an interest component (e.g. convertible debenture) or dividend component (e.g. convertible preference shares).

Convertible Debenture – A debenture is a debt instrument secured in all the assets of your business. VCs often use convertible debentures for all or part of their investment as it gives them security that they can use to move in on if the deal does not go well. The “convertibility” option allows them to convert the monies represented by the debenture into shares of the company, if doing such a conversion will give them a greater return on investment. In other words, this instrument allows them to be a secured creditor until it suits them at their option to become a shareholder. The debenture often secures the liquidation preference.

Convertible Preferred Shares - Just like a convertible debenture, but not technically debt of the company. This can have advantages as far as raising financing from third party lenders is concerned, but still ranks ahead of the common shares as far as you are concerned, with similar rights to dilute the common shareholders and take over the business if certain milestones are not hit (see *Convertible Debenture, Conversion Rate, Put Option*).

Conversion Rate - The rate of conversion from debt to equity (convertible debenture) or preferred shares to common shares (convertible preferred shares). Usually the dollars invested by the VC will convert into a percentage of the common shares of the company on a fully diluted basis at a pre-determined price per common share, at the option of the investor. This conversion rate is often the subject of intense negotiation, and may be a sliding scale or formula based on post-investment performance of the company (e.g. 30% if certain targets are hit, or up to 99.9% if certain targets are not hit)

Dividend Rights – Arise in two contexts: Firstly, the common shareholders will be prohibited from taking dividends unless the VC consents and certain conditions are met, which often means that there will no profit taking for you until the investor’s liquidation preference is paid to them.

Secondly, the convertible preferred shares might require mandatory annual dividends to give the VC the “interest” component for their Liquidation Preference. Such dividends are often accumulated but not paid out prior to certain deadlines or milestones being achieved.

Pre-emptive Rights – Enable the investor to maintain their potential percentage ownership in the company by purchasing sufficient stock in any future investment rounds to maintain their position whether or not they have already fully converted their debt or preference shares into common shares of the company.

Participation Rights - Prohibit the company from raising further investment money (debt or equity) without giving the investor a right to participate in such investment based on a pre-determined formula, usually as if the investor had fully exercised all conversion rights into common shares.

Anti-Dilution Provisions – Protect the investor from being diluted in any future financings. Do not necessarily block the financings, but make it clear that any future dilution is to the pre-existing common shareholders and not to the investor, whose potential percentage ownership in the common shares of the company is maintained.

Price Protection Clauses / Ratchets – Adjust the conversion price set out in the convertible debenture or convertible preference shares to best advantage the investor. If the company does a future transaction at a lower price per share than set out in the VCs conversion rights, the investor will get the benefit of that lower price, or perhaps the weighted average of lower prices if there are multiple transactions. If the company does a future transaction at a higher price per share than set out in the VCs conversion rights, the investor’s conversion price will not change from that set out in the convertible debenture or convertible preference shares.

Price Adjustment Clauses – Adjust the conversion price set out in the convertible debenture or convertible preference shares based on the post-closing performance of the company. Can sometimes work in favour of the owner manager, but are most often there for the benefit of the VC.

First Refusal Rights – Prohibit a non-VC shareholder from selling their shares on a good faith basis without giving the other shareholders, including the VC, the right to match the offer they have agreed to accept.

Tag Along / Co-Sale Rights – In the context of a venture capital deal, these rights give the VC an option, whenever a non-VC shareholder is selling their shares, to substitute some of their shares for the seller’s shares, thereby participating in the deal. In other words, if a non-VC shareholder is selling some of their shares, and the VC likes the price they are being sold at, the VC may “tag along” or “piggy back” into that transaction and force the seller to substitute some VC shares for some of the seller’s own shares. A formula sets out how many shares the VC can substitute into the deal to come to the total number of shares the purchaser wants to buy.

Vesting – This refers to conditions attached to additional shares that might become available to management or the employees through any option plans. In other words, additional shares may

be issued, which might dilute the investor, but only if certain conditions are satisfied, usually time and performance based.

Buy-Back Rights – Again, may apply to additional shares or options that might become available to management or employees through any option plans. The investor will insist that the company have a chance to buy-back any shares or options issued under such plans if the person leaves the company for any reason, so that the stock does not become too widely held and so that potentially troublesome non-employee minority shareholders are not created. Occasionally, but not that often, the company may have buy-back rights at a pre-determined price or formula with respect to investor shares, allowing management to reduce the investor’s percentage ownership of the company if certain milestones are met.

Exit Strategies

The heading “Exit Strategies” is a catch-all for those elements in a venture capital deal concerned with how your VC partner will eventually get their money out of the deal, whether or not the deal goes as planned. In addition, because you are not getting your money out or making any money off the VC investment unless the deal does go as planned, these strategies also represent your core opportunities to make money off the transaction.

Liquidation Preference Revisited – Just a reminder, the investor’s liquidation preference takes priority in all exit strategies. That way the investor gets their money back and their minimum return on investment before you get any money or return on investment, no matter what happens.

Approval Rights – Gives the investor a veto over any deal of any kind, or at least any deal that falls short of certain defined limits (e.g. not enough proceeds generated to cover the liquidation preference).

Prohibited Transfers - Share transfers by the founder or key managers are usually prohibited, at least prior to the investor getting their liquidation preference.

Initial Public Offering – An initial public offering by the company is often one of the preferred liquidity events, subject to a certain degree of VC approval.

Registration Rights – Applicable to potential US IPO transactions. They allow the investor to require the company to qualify the VC’s shares for public distribution as part of any IPO, and to include the VC’s shares in any registrations that permit the company to sell shares from its treasury. All of this gives the investor a great deal of say in the timing of an IPO, and ensures that the VC does not get left out of an IPO or other public issue.

Drag Along / Forced Sale Rights – The primary mechanism for initiating a sale of the whole company. Permit some shareholders to force all the other shareholders to go along with a third party sale if certain parameters are satisfied (e.g. approval of more than a certain percentage of shareholders). May also come into effect if certain timeframes or milestones are missed, or certain purchase price and payment term thresholds are crossed. The investor usually insists that

VC approval is required for all such transactions, and that the VC can trigger such a transaction on their own after a certain period of time or after a certain threshold is reached.

Put Option – An option in favour of the investor where the VC can force the company or another shareholder to buy their shares in the company at a pre-determined price or based on a formula (often fair market value) after passage of a pre-determined length of time or after certain defined thresholds are reached. This is a standard exit strategic in venture capital deals, as it allows the investor to trigger an end to their investment even if no IPO or company sale has occurred or is likely in the near future. The consequences to the company if the put option is not honoured are severe, and usually result in a forced sale of the company with priority to the investor for at least their liquidation preference.

Receivership – A final exit strategy, especially in convertible debenture based deals. The VC may reserve the right to force the liquidation of the company if the deal does not proceed as planned, permitting the VC to force liquidity within their time horizon through a forced sale or forced liquidation and winding up, at the VCs option.

Management and Accountability

As mentioned previously, your venture capitalist will want to have a significant say in your business. They will want to restrict your independence, and will want to hold you accountable. A typical venture capital deal has a number of elements that deal with these issues.

Unanimous Shareholders Agreement – Pretty much standard in all venture capital deals. Unanimous shareholder agreements restrict the power of the shareholders and transfer power to the directors of the company. The shareholders' agreement will include many of the liquidation rights and exit strategies, and most of the management and accountability provisions.

Use of Proceeds – The investor may insist on a specific agreement as to how their investment money is to be used.

Business Plan – The investor may also insist that the company be managed in accordance with an annual business plan to be approved by the VC and the directors of the company.

Information Rights – Set out the kind of information that the VC must get or can insist on so it can monitor company progress and its investment.

Voting Rights - Determine who has what voting rights. VC may insist on voting rights even if they have not exercised any of their conversion options, or may insist on disproportional voting rights.

Fundamental Changes – Gives the investor veto rights over many major decisions, including amending the company articles or by-laws, selling the company, amalgamations, IPOs, and many other significant company events.

Director Representation – Most VCs will insist on taking seats on the company board of directors as well as corporate governance procedures consistent with public companies.

Independent Directors – Many investors will require from one to several experienced, “independent” directors, so that neither the VC nor the owner manager have voting control on the board without the voting support of the independents.

Audited Financial Statements – VCs will insist that the company have annual, audited financial statements, prepared by a recognized firm of independent auditors. This is not only a level of accountability, but is often an essential step in getting the company ready for a sale or IPO.

Audit Committee – A committee of the board of directors, often with one VC, one management representative and one independent director. Audit committees interact directly with the auditor, and will receive the auditor’s annual report on management compliance with good accounting practises.

Compensation Committee – A committee of the board of directors, often with one VC, one management representative and one independent director. The compensation committee will determine salaries and compensation for the senior management team, ensuring they are fair to all parties and consistent with going rates in the marketplace.

Representations and Warranties – Assurances given by the company and its senior shareholders at the time of the investment as to the true state of the company at the time of investment. Discovery of any post-closing disparities will result in severe penalties. The risk of all pre-closing negative events, known or unknown, is passed to the pre-closing shareholders.

Affirmative Covenants – Things the company, pre-closing shareholders and senior management promise to do as part of the deal.

Negative Covenants – Things the company, pre-closing shareholders and senior management promise not to do as part of the deal.

Restrictive Covenants – Restrictions imposed on the pre-closing shareholders and senior managers with respect to any actions that could conflict with their duties and obligations to the company, including non-competition and non-solicitation clauses. These restrictions usually apply during the period of shareholding or employment, plus some period of time thereafter, so that company opportunity is not appropriated by the very people the investor is relying upon to make the deal work out. They become part of the double whammy suffered by owner managers who are forced out of their company if the VC deal does not go well – they lose their company and any say in how it is managed, and are prohibited from getting back into the same business until after some time after they cease to be shareholders, which may take years as the VC will control when and how the company is liquidated and you will be stuck as a shareholder subject to restrictive covenants the whole time.

Employment Agreements – All senior managers may be required to enter into formal employment agreements with the company, to confirm their compensation, fix their severance

packages, and restrict their outside activities, even a majority shareholder owner manager. Implicit in any such agreement is that the company board of directors, which the owner manager may no longer control, could fire the owner manager from his or her position with the company even without cause, leaving the owner manager with a significant shareholding position and a seat on the board of directors but no actual say or participation in the day to day management of the company and still be subject to the restrictive covenants referred to above.

A Closing Thought

After reading all of this you should be wondering why any owner manager would want to do a deal with a venture capitalist.

The reality is that more than 99% of successful owner managers and their businesses are not good candidates for venture capital investment, and should not even think about. Their businesses are not high growth opportunities, or the owner manager values control, independence and a modestly good living way more than they value a shot at the big leagues.

However, for the owner manager who thinks they have found a seam of gold, and are willing to risk their entire stake in the business for the kind of funding necessary to rocket to the top, then venture capital could be the only way of going after it.