

University of Colorado School of Law

ID: **1203** (Exam Number)

Exam Name: **VentureCapFinal-S1\_Bernthal\_Fall2013**

Grade: \_\_\_\_\_

Total Number of Words in this Exam = 4,267

Total Number of Characters in this Exam = 25,535

Total Number of Characters in this Exam (No Spaces, No Returns) = 21,232

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FALL 2013

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1)

===== Start of Answer #1 (18 words) =====

Part 1

Question 1:

RUW owned 10%.

9Million Pre-money + 1Million Invested = 10Million Post-money

 $1/10 = 10\%$ 

===== End of Answer #1 =====

2)

===== Start of Answer #2 (315 words) =====

Question 2:

RUW has every right to be angry. The pre-money valuation of the seed/angel round was way too high and not even close to market (assuming SB was not absolutely killing it with sales, which the facts do not seem to indicate). There are a variety of things that RUW should of asked for in the term sheet before making his investment. Two important terms he should have focused on were pre-money valuation and price based anti-dilution protection.

First, RUW should have never accepted such a high pre-money valuation. \$9M pre-money for a company without traction, a first time entrepreneur, and a seemingly uncertain future is crazy. Not only does this put RUW at a high risk for dilution in the future (in case of down rounds) it also threatens the company's ability to raise money in

the future. It is highly unlikely that a series A round (for a software play) is going to come in above \$10 pre-money, unless the company has demonstrated significant traction, something SB has failed to do (based on the facts presented).

Additionally, RUW should have asked for preferred stock and the general rights that come along with preferred stock in the protective provisions. The most important term RUW should have asked for was price-based anti-dilution protection through a full ratchet or at least a weighted average. These provisions generally protect early stage investors from the uncertainty that often surrounds early-stage finance. Because the company had not yet demonstrated significant traction, RUW should have asked for anti-dilution protection to help combat some of this uncertainty (assuming SB was not willing to accept a much lower pre-money valuation).

Lastly, assuming RUW could not get SB to lower the valuation, he should have asked for pay-to-play provision or a right-of-first refusal so that even if the company could not raise an up round, he could at least avoid massive dilution.

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===== End of Answer #2 =====

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===== Start of Answer #3 (94 words) =====

Question 3:

If the offer had been accepted, BV would have chosen not to convert to common. If BV converts they would receive 25% of the proceeds (assuming no management carve-out) so \$2.5M. In comparison, if BV does not convert, because of their 1x liquidation

preference, participating up to a 3x cap, on their preferred stock ownership they would receive \$2M (1x liquidation preference) + 25% of remaining proceeds (\$1.875M) through participation (because this does not butt up against 3x cap) = \$3.875M.

BV would receive \$3.875M had SB agreed to sell to IT.

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End of Answer #3

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Start of Answer #4 (125 words)

Question 4:

Assuming SB gets a best case economic scenario from the Knight acquisition, BV will receive \$6M of the proceeds.

BV has two options either to convert to common or not. If BV converts to common they will receive 25% of the proceeds with is equal to \$5.5M. If BV chooses not to convert (which they will because their preferred stock is worth more in this scenario) they will receive their 1x liquidation preference first, which is equal to \$2M. Then they participate with common up to a 3x cap, which is 3x or \$6M (3xinitial investment). The preferred stock would run into the cap and they would max out \$6M, which is still more than they would get if they converted to common.

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End of Answer #4

5)

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Start of Answer #5 (721 words)

Question 5:

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(★) Excellent

**Information Asymmetry:**

The first issue that many acquirers and investors face in early stage finance is the fact that the other party knows much more about the product and technology, the team, the opportunity, and usually the market than the investor or acquirer does. This is called information asymmetry. Because of this information asymmetry Knight wants to use time as a potential solution to help even the knowledge gap between Knight and SB. SB may be selling itself as a rapidly growing enterprise with massive sales projections (many of which may be used to create a valuation in an M&A scenario) but Knight has no way of having the same information that SB has. Because of this Knight can use time to reduce information asymmetry. During this time Knight can learn more about the tech, market, competition, product, etc. and this will allow them to determine if they paid a fair price or not. If they did not, they can fall back on the earn out provision and the escrow account to recover some of the purchase price (today's contract sets the table for tomorrow's negotiation).

**Agency Costs:**

The next issue of entrepreneurial finance present here is agency cost. Agency cost refers to an agent (SB in this case) acting opportunistically in a way that benefits the agent at the expense of the principal (Knight). Agency costs create misaligned incentives. Knight wants to align the incentives of SB going forward with itself (especially assuming they want the team to stay on post acquisition). To do this they are using an earn out provision and an escrow account. This will motivate SB to

continue to develop the technology and hit sales goals, and thus, align SBs incentives with Knights going forward. If SB does not continue to deliver on the projected promises of the company, Knight can deduct some of the purchase price from the escrow account. The earn out provision (3 years) uses time to align incentives and essentially forces SB to continue to have "skin in the game" and care about results. ✓

One big factor in this case is the fact that BV's fund was raised in 2003, their fund life is coming to an end and they may need to get out. In case BV is acting opportunistically, Knight's earnout and escrow clauses will help prevent BV from acting opportunistically (the way they could if the deal was cash all up front). ✓

#### **Reputation:**

Reputation is very important in entrepreneurial finance, sometimes reputation can even allow investors to get discounts on their investments (Hsu). Reputational constraints help to constrain opportunistic behavior and reduce agency costs. They are most powerful when parties involved in a deal are part of a multi-round game, there are shared expectations relating to appropriate behavior, behavior is observable by those who will deal with the party in the future, and when there are consequences for deviations from the norm. In this case, Knight may be worried about a lack of reputational constraints. First, BV is a \$50M fund raised in 2003, it is now 2013 and BV is probably ending and they may be ready to retire. IF this is the case, BV may have no need to continue to keep up their reputation and may act opportunistically towards Knight. ✓

Reputation usually acts as less of a constraint on behavior in M&A scenarios compares to VC financing scenarios because the parties usually anticipate a lower chance of future transactions. We can assume that because reputation is less of a constraint in this case, Knight pushed for longer use of time (3 and 5 years) compared to normal (18mo. -36mo.). The longer use of time will help make up for the fact that reputation may not play as big into this transaction as it normally would.

**Use of Time:**

The Use of Time in this case (3 and 5 years) allows Knight to see how things will play out before committing to the full purchase price. Use of time is a common solution to the problems of entrepreneurial finance and Knight is using it in much the same way as a VC would use Tranching or Staging. Knight is creating milestones that the earnout provision is predicated on which can help reduce uncertainty about the future value of the product and uncertainty about the market.

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 6) ===== End of Answer #5 =====

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 Start of Answer #6 (432 words) =====

Question 6:

Although the facts do not give any information regarding the health of our fund or my career, I do go through with the deal in this case mainly because of reputational constraints but also because of fiduciary duties and the stage of my fund.

**Reputational Constraints:**

Reputational constraints help to constrain opportunistic behavior and reduce agency costs. They are most powerful when parties involved in a deal are part of a multi-round game, there are shared expectations relating to appropriate behavior, behavior is observable by those who will deal with the party in the future, and when there are consequences for deviations from the norm. In this case, although it may be beneficial to BV to have a huge exit (one that returns the fund) if at all possible, forcing the entrepreneur and other investor out of a deal they want to accept will likely harm my reputation in the entrepreneurial ecosystem. Reputation is crucial for early stage investors and plays largely into VCs success via deal-flow. Unless I am about to get out of the game completely I want to maintain my reputation so I can maintain my deal flow. These reputational factors help constrain potential opportunistic behavior.

**Fiduciary Duty:**

Secondly, as a board member of SB I owe the company and its shareholders a duty to act in the best interest of the company. If this deal is in the best interest of the company, I could be sued if I forced the company to reject the deal. This brings up issues of potential liability for me personally and for my VC fund. Fiduciary duties and the threat of suit function as a constraint on opportunistic behavior. Although it is worth noting that litigation is often does not function the way it should as a reputational constraint due to a lack of publicized suits or a fear on the entrepreneurs part of suing a VC (Anastov).

**Stage of Fund:**

One major concern I have here with not accepting the deal is that the fund I used to invest in SB is probably about to expire since it was raised in 2003 and most VC funds last only 10-12 years. As a GP with obligations to my LPs I need to exit my investments so I can return funds to my LPs and quantify my results. If I skip this favorable exit opportunity I may not be able to find another one within the time period I have and this could cause major problems (I could have to sell on a secondary market and take a 50-60% haircut (Ibrahim)).

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===== End of Answer #6 =====

7)

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===== Start of Answer #7 (219 words) =====

(5) Question 7:

BV could reject the deal a number of ways.

**Protective Provisions:**

BVs preferred stock most likely grants the VC firm an ability to refuse all types of financings, mergers, acquisitions, etc.

**Shareholder Voting:**

Shareholder voting approval depends on state jurisdiction, however, if a significant portion of shareholders do not agree to the sale they can block it. In this case I would assume because BV owns all preferred stock they may be able to vote down the sale

even without the protective provisions because they would vote all of their class of stock against the sale. A buyer usually wants a clean transaction (90% of stock) so this could be a major increase in transactional costs for Knight and a major detriment to Knight's desire to buy.

**Threaten Suit:**

BV could threaten to sue the company as a shareholder, for breach of fiduciary duty because the board was acting to self-deal and not in the best interest of the company. Even with no merit a suit in and of itself could be enough to scare off potential acquirers. This would increase transactional costs of the deal and potentially ruin it.

**Threaten to sell shares on secondary market to a competitor of Knights:**

This would complicate the deal and likely make Knight drop out because of the hassle.

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===== End of Answer #7 =====

8)

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===== Start of Answer #8 (830 words) =====

**Question 8:**

As a startup CEO there are both positives and negatives about this new Access system, however, because this system seems to create more problems related specifically to early-stage technology and entrepreneurial finance than it actually solves, I prefer the more traditional US approach. Although some people have predicted a change in the VC model, believing that Asset aggregation will not exist in 20 years (Fred Wilson), experiments with syndicates on platforms like Angellist have so far

demonstrated more problems than solutions. As a startup CEO I believe that the traditional model better aligns my incentives with my investors and provides me with more access tacit knowledge. Additionally, I believe that I although some transaction costs will be reduced through this platform, I think it creates more hoops for my company to jump through than the traditional system and forces me to spend time and resources I don't have creating detailed projections about an uncertain future (entrepreneurship and startups are by definition fraught with uncertainty). Lastly, the new requirements (publicize all info) will actually put me at a competitive disadvantage.

### Pros:

#### **Transaction Costs:**

There are some pros of the Access system. First, It seemingly reduces transactional costs associated with the deal. Transactional costs are a problem of early stage finance. Electronic platforms can reduce transaction costs by dropping the finder's cost, the cost of finding an investor drops dramatically, giving me as startup CEO, more time to work on my company and less time to spend chasing investors. Additionally, with Access it seems that diligence is aggregated so uncertainty will be reduced for a larger number of investors. Because transactional costs increase friction and decrease the chances that a deal will occur, startup CEOs like anytime transaction costs can be reduced because they are more likely to get funded.

#### **Access to Investors:**

As a startup CEO I also like this platform because as it grows I will have more access to

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more money. Although this could result in a sever overheating of the market similar to what happened in 2000 (Bankman and Cole) for me as a startup CEO, I am happy to have more chances to raise money. While the money may be "dumb money" I may be happy to have any money I can get, especially if I am a CEO who may not have had the ability to raise money in the traditional model of finance. ✓

### **Cons:**

#### **Transactional Costs:**


Although this platform seems to decrease transactional costs it may increase them in the net because it requires significant disclosures on the part of the company. Requiring companies to create a PPM, B-plan, financial projections, etc is crazy when early stage companies sometimes don't even know what their product, market, or business plan is yet. This could trap entrepreneurs into what they say before they raise money, and although it seems to reduce uncertainty, it may actually reduce a startups chance of success if they are afraid to pivot or else face legal charges. Also, investors can be a headache for startups and sometimes are the biggest source of stress, even more then competitors (see Paul Graham's essay from 2010 exam). More investors could create more transactional costs and frustrations for startups and may lead to more startup failures via micro management, especially when investors are less sophisticated. ✓

#### **Increase in Agency Costs:**


having no legal ramifications for potential agency costs or self-dealing behavior could be catastrophic for the entrepreneurial and early-stage finance landscape. Although this

may be good for me as an entrepreneur it may cause harm in the long term. If I can get a safe-harbor under the new rules I may be more willing to act opportunistically or take risks I wouldn't have otherwise taken.

**Public Information:**

 The new requirements make me as a CEO reveal all information about my company to the public. Traditionally, my private information is one huge advantage I have as a startup on big corporations (The Innovator's Dilemma). If I am required to publicize all my information I increase my chance of being copied and destroyed by a large company with more resources. ✓

**No Help with problem of Tacit Knowledge:** ✓

 Startups need guidance and mentorship which is often provided by early stage investors who have experience and pattern-recognition skills that are different from an every day stock-market investor (Jaffe and LEvenson). Boards offer social capital, intellectual capital, and interpersonal capital, all of which are important for an unexperienced entrepreneur and provide guidance, potentially increasing the likelihood of success. Also many entrepreneurs are manics, which although provides an edge at times, also needs guidance a role that an experienced board member often plays (Hypomaniac edge). Although not explicitly stated, it seems that this new platform may reduce the amount of ownership a VC takes in a company because more people have access to companies and because information is public. This will decrease the alignment of incentives between a VC and startup and reduce the help a CEO can get ✓

from her VC.

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===== End of Answer #8 =====

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===== Start of Answer #9 (628 words) =====

Question 9:

*Exclusion*

RealDeal (RD) should accept the term sheet from Fiona VC (FVC) because the FVC offer increases the chances that RD will be a huge success and make everyone rich. If RD was attempting to sell this company quickly to a bigger acquirer within a short time period the company may be smarter to accept the Bears offer because it results in them owning more of the company (assuming no other capital is needed). However, based on the size of the growing market and the massive impact this product could have on the world, I will assume that RD is in it to win it and wants to have a huge Billion dollar exit. ✓

**Bears Offer:**

**Pros:**

The Bears offer is much more favorable to the RD in terms of economics. It is a higher valuation, offers a tiny option pool, and asks for very limited anti-dilution protection.

**Cons:**

The Bears offer does not maximize the companies chances of success. The Term sheet indicates a lack of experience and does not help RD (social capital, intellectual ✓)

capital, interpersonal capital (Jaffe and Levenson)) outside of providing them with some cash. Bears doesn't even ask for a board seat so it seems she is not interested in providing the company with anything besides straight cash homie.

**FVC:**

The FVC offer sets the company up for success in the long-term and provides many benefits to RD outside of money alone.

**Pros:**

First, FVC offers RD way more in terms of tacit knowledge. Tacit knowledge, the knowledge you get in the field or street smarts, is one of the problems of entrepreneurial finance because many new founders don't have it. FVC taking a board seat is a good thing for RD because they can offer all the benefits mentioned by Jaffe and LEvenson in their article about Board Value. FVC can has experience scaling companies and can guide RD along the path to success.

Secondly, FVC brings a fantastic reputation to the table. This reputation probably explains why they want a lower valuation. Most startups are willing to give this discount to VCs with great reps because they know it will benefit them in terms of hiring, PR, and product validation (in addition to the mentorship and guidance) (Hsu article). RD will have an easier time getting press, hiring rockstars, and connecting with partners simply because they are backed by well-known VCs with great reputations.

Next, FVC is probably more likely to have the funds available to support RD through its life-cycle. FVC is in this thing for the long haul whereas Bear, an angel investor may be looking to only fund one or two rounds. This increases the likelihood that RD will succeed because it reduces the uncertainty of future fundraising and allows the entrepreneurs to spend more time building the product and business and less time begging VCs for money.

Also, the employee pool here, although dilutive is a good thing. 22% isn't that high (although the entrepreneur should stay weary to the fact that it is high enough to bring in a replacement CEO, though unlikely without founder consent due to great reputation of "One-eye) and it is forward-looking, giving the company room to hire the rockstars they will need to get to the next level.

The board seat helps the company because the VC can provide guidance and tacit knowledge but it also helps constrain opportunistic behavior by the CEO or other founder through monitoring. The most successful companies are created when incentives are aligned

**Cons:**

There are some cons here including: the dilution to the entrepreneur (22%) through the option pool, the lower pre-money valuation resulting in RD giving up a higher % of equity, and the 1x participating up to 3x cap liquidation preference.

=====**End of Answer #9**=====

10)

=====**Start of Answer #10 (319 words)**=====

**6** Question 10:

The LPs are incorrect because their statement assumes that the only role of the VC is to source deals. Although sourcing and diligencing deals is one of the benefits of investing in a VC fund, the MDs of a VC fund provide far more value in helping companies succeed. Additionally, just because the VCs no longer have to hunt deals doesn't mean they don't still have to choose the correct deals. ✓

Reducing the carry may reduce VCs incentives to help companies with activities outside of finance. VCs play intregal roles with early stage companies including adding reputational halos (Hsu), monitoring and reducing agency costs, mentoring and helping with pattern recognition and the need for tacit knowledge through their role on the boards of their portfolio companies (JAffe and Levenson). Without this role of monitoring agency costs are increased. ✓

If VCs compensation structures were reduced (which would misalign incentives completely opposite to the way that the Yale endowment office did when they found success) they may be less incentivized to help companies succeed and more incentivized to invest in lots of deals and take more of a "see what sticks approach." Although this could be limited by forcing the VCs to maintain some significant skin in the game and participate in the fund alongside LPs, reducing the carry management fee ratio generally has negative results. VCs may be motivated to increase the size of

their funds and to get fat off of management fees ( Bankman and Cole).

VCs also provide value in actually choosing the companies, although the information is now public, reducing the information asymmetry some VC firms can acquire through diligence (See Yale), the VCs still have to pick which companies will succeed and which will fail. VCs offer a way for LPs to indirectly invest in companies while reducing uncertainty. The best managers are able to exploit information asymmetries and produce excellent returns (Yale). ✓

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End of Answer #10  
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Start of Answer #11 (566 words)  
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Question 11:

Assuming, as the fact pattern suggest, that Berthalistan (Country) is small geographically, it is in Jendelson's (J) best interest to help the surrounding towns and increase the nations entrepreneurial ecosystem as a whole rather than focusing on J's town alone. The following argument assumes that the country is small enough to be one network. ✓

First, J should think about Sexenian's work on educational systems and economic geography. For example, in the US in the 60s and 70s higher education was easily the best in the world so the best and the brightest came to study in the US and then stayed in the country. Once conflict around the world settled and other countries became more ✓

stable, some of these immigrants did move back to their home country, however, most of them created companies that were complimentary rather than competitive, which ended up helping the US economy and business scene. J should consider the country as a whole and the benefits the country could have if people wanted to migrate into the country. Also, if people come to work in J's town and have the ability to move back to W or GC (other towns) they may be able to create complimentary companies with the local resources that these cities have that Mendelville doesn't.

Second, J should consider Saxenian's work comparing S-Valley to Route 128 and think about Open versus closed systems. S-Valley was ultimately much more successful by breeding a culture of open communication, open source, and horizontal integration, this created external economies of scale, knowledge spillovers, and agglomeration economies, which ended up drastically helping S-Valley succeed. Mendelville should open-source its innovation economy efforts because it could benefit from the lower costs associated with concentration (within the country as a whole) (external economies of scale). More talent (engineers, scientists, service providers, etc.) is good for everyone and as the nation grows and becomes an entrepreneurial powerhouse more talent will come to the nation (Agglomeration economies - Marshall and Saxenian).

Additionally M could benefit from the network effects of adding more creative class members to the country. With a network, the more users that are added to the network, the more valuable it becomes. Cities, like startups are rarely self sufficient or vertically integrated. Because of this they require a range of specialized assistance that comes from outside the city. A larger countrywide network could make M more valuable in and of itself.

Another reason M should share information with surrounding cities in the country is because horizontal integration generally provides the best outcomes. If perhaps GC can provide a piece of hardware easier than M can, companies in M may be able to start using this piece of hardware and innovating instead of trying to produce everything themselves. ✓

Additionally, as things get bigger they continue to accelerate and knowledge spillovers occur (West). This could be good for M because they could mesh ideas with other cities and improve innovations. For example, M may have a lot to gain by meshing ideas with GC and W because of these cities strong and legendary arts scenes which probably attract a creative class of people (Florida). Also, as Glassier states, cities are important for environmental reasons. The last thing M would want is for other cities in the country to cause market externalities, like pollution, that M would have to pay for due to its sustained success. ✓

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**END OF EXAM**