

University of Colorado School of Law

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===== Start of Answer #1 (21 words) =====

3) RUW put in \$1M on a \$9M pre, for 10M post, so RUW owns 10% of the company after the investment.

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

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===== Start of Answer #2 (304 words) =====

5.5) RUW is not an experienced angel and as a result has not set up a situation to protect him against issues related to price in future rounds of financing. RUW should have set up the financing as a preferred stock arrangement so that he can include protective provisions that will protect him against issues such a lower valuation (down-round) in the future (Shintom article, SFC 2012 Report). We know from the Ibrihim article that the comparatively "simple" angel contracts make sense because they can entice follow-on investments, but in this case it is surely to the detriment of the angel investor who has taken on a high degree of risk at the beginning of the company's life.

The two issues that RUW can address differently next time in the contracting phase are price-based anti-dilution and super pro-rata rights for future rounds of financing. Price-based anti-dilution, which can range anywhere from full ratchet to broad and narrow-based dilution, protect an investor from dilution in future rounds of financing with a lower valuation. This would protect RUW's investment from being diluted when BV ventures comes in with a 2M investment and a 6M pre-money valuation. This provision protects RUW from the high degree of uncertainty present in the early stages of

financing.

Secondly, Super pro rata rights allow an investor to purchase beyond its weight and purchase a greater percent of equity in a later round. From the investors perspective, this flips the agency cost scenario where the investor now has the right to act opportunistically and buy shares at a lower price in future rounds. However, this may not be attractive to the angel if things aren't going well (hence the need for a down round), but it does provide some upside to the angel who comes in at such a high degree of uncertainty.

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

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===== Start of Answer #3 (59 words) =====

BV would have received 4M from the 10M sale. He would first get 2M in liquidation preference and then participate in the remaining 8M. Since BV owns 25% of the company, he would get 2M out of the remaining 8M, for a total of 4M.

He would not convert since this would result in 25% of 10M, or 2.5M.

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===== End of Answer #3 =====

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===== Start of Answer #4 (192 words) =====

After the Series A round of financing, the equity split is as follows: BV owns 25% (2M investment on a 8M post-money deal), and the CEO and RUW are left to split the remaining equity (75%) between the two of them. Because RUW didn't negotiate for

any price-based anti-dilution protections, they are both diluted pro-rata. Since RUW owned 10% of the company before the Series A, he now owns 10% of 75%, or 7.5%. The CEO, who owned 90% before, now owns 90% of 75%, or 67.5%

In the best case if BV converts, BV gets 25% of 22M, or 5.5M. If BV does not convert, BV first gets the 2M liquidation preference, then participates at 25% of the remaining 20M, for 5. However, his preferences are capped at 3X LP, so BV gets 6M of the best-case 22M offer. 6M is greater than 5.5M, so BV would not convert.

Given the liquidation preference, BV would get the entire first 2M up front, and would then participate pro-rata as if he were a common shareholder as the remainder of the funds come in (gets to have his cake and eat it too).

===== End of Answer #4 =====

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===== Start of Answer #5 (632 words) =====

i). Information Asymmetry: The start-up venture has been around since September 2003, so the entrepreneur and the early investors have a lot of history and knowledge about the company. On the other hand, Knight Inc. is new to the relationship and does not know as much about the company. This information asymmetry, where one side knows more than the other side, creates problems in entrepreneurial finance. For example, the party with more information may act opportunistically because he/she has this information. By including the three year earn out and the five year escrow, Knight is hoping to counter the "lemons problem" by asking the company to accept this

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arrangement and certify their claims about the value of the company.

ii). Agency Costs: Agency costs result where the agent acts opportunistically at the expense of the principal. Agency costs could be expected in this situation given the high degree of information asymmetry between the two parties. By including the three year earn out and the five year escrow, Knight is hoping to align incentives in this arrangement; Knight wants to be sure he is getting a good deal for his money and wants the entrepreneur's help in making the company worth his investment. By tying incentives to performance metrics such as sales goals, Knight can incentivize the entrepreneur to help the company do well over the next three years. We saw an example of aligning incentives (on the VC side) in the Yale Investment article

iii) Reputation: As a VC, Knight may be well-connected to other entrepreneurs and investors in the area. He likely has a strong network and maintains that network by keeping in touch with his community. In fact, this is one of the non-financial values that Knight brings to the table as a VC (Hsu and Gomper article). Knight may be using the earn out and the set aside to couple the use of time with the idea of reputation to keep the founder in check and make sure that Knight is getting a good deal. If he is not, or the CEO does not deliver as promised, Knight can affect his reputation in the area, which would hurt his chances of attracting good talent to his company or perhaps enticing investors in the future. Because Barry is a rookie entrepreneur, his reputation is not yet established, so the opportunity to build his reputation in the eyes of Knight might be very important. On the other hand, we might be afraid that, since this is the entrepreneurs only company, that it is a "one time game" where the remedy of

reputation might not apply. However, given that the entrepreneur has been with the company for 10 years already, we might assume he is in it for the long haul.

On the other side, a VC also uses reputation to allow for better deal flow, lower prices, and perhaps here in this case, the patience of the entrepreneur to deliver the funds. If this is a high-performing VC, we could expect that his skepticism in the company and the need to tranche payments over time is justifiable. The entrepreneur might be willing to "pay" in the form of time for the opportunity to work with this VC, to make the deal happen. A low-reputation VC might not be able to get away with the same terms.

iv) Use of Time: Using time is a way to minimize uncertainty and information asymmetry in the deal. By waiting to give BuffCo most of Knight's investment until performance milestones and other criteria are met, Knight is using time to align incentives and learn whether the uncertainties Knight had at the beginning of the investment were indeed valid. If his concerns were justified, then the use of time has saved Knight from a bad investment. ✓

===== End of Answer #5 =====

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===== Start of Answer #6 (372 words) =====

From the perspective of Boyle Ventures, I would not want this deal to go through the way that it is structured at this point. ✓

For one, the timing of the payouts is not very attractive to me as an investor given that the BV fund is near the end of its life and BV has obligations to its LPs to return money ✓

for the money it has invested over the life of the 2003 fund. The \$50M BV fund was started in 2003, and assuming the fund is a 10-year fund, now that it is 2013 the fund is wrapping up and LPs are expecting to receive their returns. BV could provide 2M back to its investors at the closing of the deal, but most of the remainder of the payout will come at the end of the 3 year earn out (BV would earn 25% of 15M, or 3.75M, which added to 2M is 5.75 or most of the cap on participation. These time expectancies and other restrictive covenants are included in the limited partnership agreement (Gompers)

Also, the time involved in staying with this investment, even if BV can get permission from its LPs to stay involved, is likely a strain on BV's ability to manage their time efficiently. A five year extended horizon with this company means that BV needs to stay involved throughout that time period, which includes a host of monitoring functions that VCs perform, including taking a board seat, doing strategic advising, acting as an HR assistant, accountant, and monitor of corporate governance (Gilson and Gompers article). Given that the future financing is tied to performance milestones, a VC would likely need to be even more involved in the company to make sure these milestones are met, with puts a further strain on the VC and their resources (and time is money).

Looking at this arrangement from a purely economic perspective, the VC needs to consider the time value of money and what the opportunity cost associated with keeping the fund's money with that company for so long. Even if the VC does get the 6M back over time, it is worth a lot less after 3 and 5 years than it is worth in 2013.

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

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=====**Start of Answer #7 (172 words)**=====

It is not impossible for BV to reject the deal, but BV's ability to reject the deal mostly depends on the protective provisions that have been agreed to at the time of the Series A financing. We can see that the Series A financing included standard protective provisions, which likely included drag along and tag along or co-sale rights, which prevent hold out situations such as BVs desire to reject the KI deal. ✓

Also, given that BV only has one of the three board seats, he would not be able to reject the deal via a board vote, but if he is able to convince one of the other members that the deal is not favorable (likely RUW), they may be able to prevent the deal that way. ✓

Even without the necessary protective provisions in place to prevent a holdout situation for BV, BV still has dissenters' rights which protect the minority shareholder from getting a bad deal. This could, however, eventually involve legal action, which could be expensive and time consuming. ✓

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

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=====**Start of Answer #8 (706 words)**=====

Although the Access platform is interesting and could potentially revolutionize the startup community in my country, as a CEO I am not entirely convinced that I want to move from the traditional model to the Access platform given the arrangement put in

place by the government. I do believe what Fred Wilson wrote in that the VC industry is not sustainable the way that it is today, but Access is not the sole solution.

Delaware Law - One advantage of using a single legal system across the entire country is that it probably reduces transaction costs for deals to get done. This would allow more standardization of forms and legal processes, which would reduce my costs as an entrepreneur. On the other hand, even if this seems like a great idea from an entrepreneurs' perspective, I might be afraid that having one system across the entire country reduces the opportunity for experimentation among different areas. We've seen in the US how states are the laboratories of democracy, so we might be missing something exciting and creative by deciding to go with one system across the entire country.

All Equity - The decision to only allow funding to be done with equity is not attractive to me as an entrepreneur. I have started multiple companies as a CEO and there have been many cases when convertible debt has been just the right tool for us at that point in time. Using equity would require my companies to set a valuation, which in many cases there is just so much uncertainty at early stages of the game that this just doesn't make sense, and could hurt both me as an entrepreneur and my early stage investors. I understand the Angel Paradox and its contrast perform between the uncertainty that early angels take on coupled with the simple financing terms they use, but I like to the idea of including more VC-like terms in the deal and including other provisions for the Angel so that I still can use that debt (thus punting on the valuation)

and provide some upside for the angel investor at the same time. Funding deals with only equity really limits my options and only burdens me as an entrepreneur.

Requirement to use Access - I am not convinced that a government platform can run efficiently (having just seen what happened with healthcare in the US) and am therefore not comfortable with the fact that Access is my only option for getting the deal done. As a startup entrepreneur, I believe in innovation, and I know many people who can develop their own software platforms that can perform very well compared to a large, clunky government system. I'm afraid the government would behave like sustaining innovators and only listen to their existing customers to meet their needs, when what I am more interested in is disruptive innovation (Christensen). I don't want to shut out disruptive innovation that could lead to more opportunities for deals, and a better system to get them done on. I do understand that an Access system would provide standardization that would reduce transaction costs, but I believe the benefits from an open system that creates opportunities for innovation is more valuable to me as a startup CEO.

Financing offers visible to company and potential investors: The final aspect of the Access proposal that makes me uncomfortable is the fact that financing offers are visible to both the company and potential investors. This really puts me as the entrepreneur at risk. Especially considering the fact that both sophisticated and unsophisticated investors can participate in financing and make offers, there is a high degree of information asymmetry in the market, which could could my chances of

getting a good valuation and offer once a bad offer is made. We know that people's minds anchor around numbers and ideas that they have seen, so even if a sophisticated investor knew the offer was not legit, it still might hurt my chance of getting a favorable valuation. In addition, posting offers also limits my ability to use Information Asymmetry to my advantage in deals, which allows me to shop around for different offers from investors and get what I feel is best for my company.

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===== Start of Answer #9 (736 words) =====

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There are a number of things that I like about working with an experienced, high reputation VC like Fiona, and if I was choosing between SB Angel and Fiona I would choose Fiona. For one, there is a strong certification value that my company could get by working with someone like her. I believe that the three criteria set forth in the Hsu article are all present to make me believe that Fiona would provide that certification value to my company.

I am also comfortable with Fiona's desire to take a board seat. I am glad to have an experienced VC like Fiona sit on my board and contribute to the management of my company. As we know from the Jaffe article, boards bring social capital, interpersonal capital, and intellectual capital, which all add value to the company. In addition, I like knowing that I am working with a high reputation VC because I believe this will help reduce the common problems of entrepreneurial finance including information asymmetry and lack of information between me and my investor. Fiona has spent over 25 years developing her reputation so I could be relatively confident that she wouldn't

do anything now to jeopardize that relationship. This also helps me to put faith in her recommendations and the offer she makes to finance my company. However, we do know that there is a premium associated with working with a high caliber VC (Hsu article) that I believe that the "extra financial" aspects of working with Fiona are worth it to me. On top of the reputation and certification value that Fiona brings to the table, I am also drawn to the network that Fionas can bring to help the company, given that she has been a VC for a long time and has been local to the area. This network can help me attract talent to my business and get help finding resources that I need to grow to become the market leader in human protein detection. If I want to be the market leader, a strong VC like Fiona could be just what I need to help me get there.

The cons of working with Fiona related to the economic results of the equity she will take in the company and the option pool required that will dilute my ownership from 80% to 58%. Other considerations for working with Fiona would depend on how much money this VC has for follow-on financing that I might need, how much time Fiona has to commit to me given everything she has going on right now (although reputation is constraining factor here), and how experienced Fiona is in my particular field and how well my business fits within Fiona's investment thesis to know how valuable her experience is in this area.

SB Angel Deal: On the other hand, what I like about the SB angel deal are the benefits the deal offers in terms of the economics and control it brings to me as an entrepreneur. For one, the liquidation preference and other provisions in the terms of the agreement make it so there is a large financial upside to me as an entrepreneur if this business goes big, as I expect it will do over the next 5-15 years.

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The low option pool also works for me because it prevents me from being diluted by the establishment of that option pool. However, given that the option pool will be necessary in order for me to attract talent, I would probably prefer that we set some options aside so that we can attract good talent. ✓

Given that SB Angel does not have a ton of experience and networks in the area, I am happy that SB is not requesting a high degree of control through a board position. However, SB's lack of experience most of a downside than help for my business. Given that SB is new to the area and does not have a lot of experience as an investor, I am not going to be able to use SB's network to attract new employees or gain access to resources in the area. ✓

My decision to work with Fiona strongly depends on whether more funding is going to be needed, because I really do anticipate needing the other "value-added" aspects that a VC brings to the table in order for my company to really go big like I hope it will. ✓

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===== Start of Answer #10 (337 words) =====

No, I do not believe that the LPs are correct in their assumption that Access will reduce the need for management fees. ✓

It may be the case that the system becomes so streamlined that it really does help VCs find new companies to invest in, however, the VC may still prefer to build their deal flow in traditional ways that work well for them (incubators, accelerators, attending conferences, etc), all of which are done offline and take time. ✓

I would also argue that it should not matter much to the LPs whether they are offering 2% or 1% to the VC, because both are low enough to not make the VC rich (which would create agency costs), and the management fees are essentially a loan to the VC from the LP that the LP will make back assuming that they are working with a quality VC firm. ✓

Finally, reducing the management fees may create some unintended consequences for the LP. With a low fee, the GP may be incentivized to make money in other ways. This may result in the VC harvesting a company sooner than it should, which would reduce profits for the LP. It may also induce the VC to find other ways outside of the fund to make money (reducing focus on their fund) or possibly participating in risky behavior (like making money in Vegas). ✓

With low management fees, one could also argue that VCs would be incentivized to raise larger and larger funds so that they can have sufficient salaries to do their jobs, and these large funds may not be in the best interest of the VC, or the LPs. However, one counterpoint is that the VC firm makes vastly more money from carry, and thus the tendency to raise new funds purely for the management fee is countered. ✓

In the end, the most important thing for the LPs to consider is how to create the greatest incentives for the VC to manage the funds well (which is largely done through carry).

=====**End of Answer #10**=====

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=====**Start of Answer #11 (499 words)**=====

• To the extent that it takes away resources from focusing on my own city, I would not endorse collaborating with other cities, but in reality I think that this collaboration is a good thing for the city of Mendelville to collaborate with these other cities. For one, Saxenian argued in the New Argonauts article that there is a cross-regional benefit to immigrants who have come to work in the United States and gone back to their home countries. These individuals have formed connections across geographies that are proving very useful in the global economy. Saxenian argues that this version of regional advantage creates new businesses and increases prosperity overall, and I tend to agree with that argument.

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• in addition, although we are seeing increasing concentration in certain hubs and we know from Glaeser that the three largest metro areas account for 80% of GDP but only 13% of the population, restricting information and collaboration within these geographic boundaries would be to the detriment of the cities. Like we learned about a VC's investment philosophy, the regional VCs who only invest in one region are often at a disadvantage to other VCs who take a more "portfolio approach" to their investments and spread the risk over time and space. This is also the same strategy that worked so well for the Yale investment team.

I believe that viewing cities as independent, self-sufficient (autarkic) entities, the city of Mendelville might fall into the same trap as the companies on Route 128 (Saxenian) who secrecy and centralized authority only proved to work to their detriment when compared to the success of more decentralized, networked businesses. I would advice MJ to take these lessons and apply them to his approach in working with other cities, so that they can build a cross-regional advantage that, over time, acts as a diversification strategy that also strengthens all cities and increases prosperity for the group as a whole. This collaboration could also help take advantage of each cities' own specializations and resources that other cities may not have. Strong relationships with these other cities could lower the cost of procuring these resources in the future, and allow individuals to find more "like-minded" people with whom they can work.

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On the other hand, it is important to remember to build and enforce the strong ties that are already being built within the Mendelville city. Saxenian did argue that there are benefits to spatial proximity (agglomeration economies) that do provide value in a city, and the Allen Curve also illustrates the importance of proximity and how it factors into how we behave and who we work with. Network effects and external economies of scope also help explain why focusing solely on the city of Mendelville would be more beneficial to its citizens, but in the end, I would take a more inclusive perspective and advocate that Mendelville collaborate with other cities to the extent that effort can be deliberate and well-managed from a fiscal perspective.

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