Deals

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**Discussion Questions # 3**

**Venture Capital: Staged Financing and Incentive Compensation**

1. Assume that Ellen has an idea for a new business. She wants to hire professors to teach courses online, and to charge people for taking these courses. But Ellen needs money to start “Learn-online, Inc.” She has two potential investors. One, Schoolco, is an educational institution. The other, Pensionco, invests money for the police department in order to be able to pay pensions to retired policemen.

1. Which of these investors has potentially greater expertise about the subject of Ellen’s business? In what ways can investors potentially add value beyond their investment?
2. If Ellen was also asking you to invest, would you care who the other investors are? Would you be more likely to invest if you heard that the other investor was Schoolco or Pensionco?
3. Ellen plans to be the CEO of this business. In addition to wanting the investment, she also wants to make sure she will not be replaced as CEO. Review -- what is this sort of conflict of interest called? In pursuing this second goal (of keeping her job), does she have a reason to prefer one employer over the other?

2. On January 1, Ellen will need $200,000 to hire technology consultants for six months to prepare the website. The effectiveness of the website is going to be quite important in determining the success of the business. Six months later (on July 1), she will need $200,000 to hire faculty to teach the courses, which will begin on September 1. The quality of the faculty will obviously also be important.

In response, Pensionco offers to buy 500,000 shares of Learn-online, Inc. – representing half of the company’s 1 million shares – for $400,000. They would pay $200,000 on January 1, and $200,000 on July 1.

But Schoolco’s offer is different. They are offering to pay $250,000 on January 1 for two things: first, ¼ of the shares of the company (250,000 shares); and second, an option to buy another ¼ of the company (i.e., another 250,000 shares) on June 30 for $250,000. Although Schoolco would have the right to buy these additional shares, they are not obligated to do so.

a. Does each offer ensure that Ellen has the money she needs to launch the business?

b. Why might Ellen be tempted to take Schoolco’s offer? Why might she be worried about doing so?

c. Why do you think Schoolco is willing to pay more? What are they getting in return? Why do you think they value the extra business term they are seeking?

d. Let’s say Ellen makes a counteroffer to Schoolco, saying she will agree to their terms if they agree to decide whether to make their second investment – not on June 30 (after six months) – but on January 6 (after six days). If you were advising Schoolco, would you think this change in timing is significant?

e. If Ellen is unwilling to take Schoolco’s offer, does that tell us something about her prediction for the business?

3. Assume that Ellen takes Schoolco’s offer. Assume also that six months later, Schoolco decides not to buy the additional 250,000 shares. At that point, Ellen goes back to Pensionco to ask if they want to invest. If you are advising Pensionco, would it matter to you that Schoolco had decided not to invest?

4. What is a “right of first refusal”? Why is it costly to grant one? If it is, why would anyone offer one?

5. Do you agree or disagree with the following statements?:

a. As long as the underlying business makes sense, it doesn’t matter who owns it or how the ownership is divided.

b. In structuring a new deal, we should use the structure from a past deal as a model (or “precedent’).

c. We need to structure a deal to reflect what each party brings to the table.

d. Current structuring can affect future bargaining.

e. When we structure a deal, we need to focus on the information each party has (or does not have).

6. What is venture capital? What type of businesses do venture capitalists (“VC’s”) finance?

7. A Columbia law professor named Adolph Berle (writing with Gardiner Means) identified a problem in public corporations, which they called “separation of ownership and control.” The problem was that there were so many owners that individual owners did not have an incentive to monitor the business, so managers had too much power, which they could use in self-interested ways. Does this problem arise when venture-capitalists make investments?

8. Venture capitalists often specialize in a particular sector. Why?

9. Do venture capitalists usually invest all at once or invest in stages? Why?

10. Beth offers you the following proposal: If you invest $1,000, she will use it to develop a cure for the common cold. She is close to a cure, but there are no guarantees. If she is successful, your $1,000 will be worth $100,000. But she could fail, leaving you with nothing. What risks do you see in this proposal?

a. In dealing with these risks, are you comforted or are you more nervous if this investment is one of several that you make? Does diversification help with uncertainty? Or asymmetric information? Or agency costs?

b. Does it matter if you personally have expertise about developing drugs? Can this expertise help with uncertainty? Or asymmetric information? Or agency costs?

c. Let’s say that Beth is very wealthy and can finance the investment herself. Is that fact relevant to your decision about whether to invest?

d. Let’s say you learn that Beth is going to do some of the relevant research as part of graduate work she is doing in biochemistry. Is that relevant to your decision? How might it be helpful? How might it be unhelpful?

e. Let’s say you learn that Beth plays a lot of golf. Is that relevant to your decision?

f. Can we use a contract to address the risks you have identified? If this is hard to do, why is it hard?

g. Do you agree with the following statement and, if so, why? “An organization can substitute for a contract.”

11. Would it help if Beth in the above problem is paid a small cash salary, and her main compensation is shares in the new venture? When an entrepreneur and a venture capitalist strike a deal, how is the entrepreneur usually paid? Why?

12. Steve founds a computer company. He takes a modest salary and owns all the equity in the startup. He comes up with a new type of personal computer, and needs capital to produce and sell them. Venture Capital invests $2 million in exchange for convertible preferred shares, which can be converted into common shares representing ⅓ of the company. The preferred stock has extra voting rights, entitling the VC to four of the company’s six board seats.

1. Is it typical for VCs to control the company before it goes public?
2. Why or why not?
3. What risk does an entrepreneur take in giving venture capitalists control rights?
4. When do venture capitalists lose their control rights? What incentive does this create for an entrepreneur?
5. Are there reasons why a venture capitalist might hesitate to fire an entrepreneur, even if she has the legal right to do so?

13. So far, we have focused on the relationship between start-ups and their venture capitalist investors. But there is another relevant relationship: Venture capitalists often have partners in their funds, like universities and pension funds. Let’s turn to the issues that can arise in that relationship and the ways VCs address them.

1. We have discussed incentive and information problems that arise when VCs invest in startups. But are there incentive and information problems that arise when universities, pension funds, and other investors invest in VCs? How do the latter issues compare with the issues the VCs themselves face in deciding whether to invest with an entrepreneur?
2. How do universities, pension funds, and other investors compensate venture capitalists? Why do you think the pay takes that form?
3. If a university invests in a venture capital fund, is there a particular date on which it is supposed to get its money back? Why are VC funds structured in this way?

14. Assume that University invests $1 million with VC. University agrees to pay a 2% annual fee ($20k), and also to share 20% of profits above a 10% annual return (called a “carried interest”). VC uses University’s money to invest $500k in each of two ventures, A and B.

1. After two years, VC sells its position in A for $1 million, doubling University’s money. A 10% return on $500k over two years is approximately $100,000. The profit above that level, therefore, is $400,000. How much should VC receive?
2. What if B goes bankrupt in the following year, so that University loses all $500,000 invested in it. Obviously, VC gets no carried interest for B, since there is no profit. But is there a problem with the carried interest that VC has already claimed for the investment in A.
3. What is a clawback, and why are they included in VC funds?
4. Under U.S. law, does the “carried interest” earned by by the VC seem more like salary or an investment? Do you know whether it is taxed as ordinary income or capital gain?

15. Which of the following terms do you think are likely to appear in University’s contract with the VC.

1. University generally will have its capital returned by a set date, with a limited exception for exceptional circumstances.
2. The VC cannot sell or transfer its general partnership in the fund to anyone without University’s consent.
3. The VC cannot invest in businesses owned by individual partners in the VC firm or their family members without University’s consent.
4. The VC cannot operate any other funds.