Virginia Business Lawyers

Point Number 7 on How To Pursue Venture Capital

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"The time has come," the VC said, "to talk of many things - Of Points and Pies and Preferences and Option Grants with Strings" (With apologies to Lewis Carroll)

"Nothin' from nothin' leaves nothin'." Billy Preston

"42.7 percent of all statistics are made up on the spot." Stephen Wright

Know your ownership position. In our last post, we discussed being prudent about what you say to the venture capitalist or fund management. This post, however, is about being careful about how the raising of capital affects share of ownership and business success.

Don't sacrifice your start up to the false god of majority ownership. It's a common mistake to view ownership and control in a one-dimensional framework. What could be simpler, there are hundred percentage points and if you have more than 50 of them, you're the boss, right? And that's a good thing, right? To which I respond: "no" and "maybe."

The venture capitalist's model capital structure is not based on a simple division of ownership (we'll talk about that next time). There are plenty of good reasons for this, and it's mutually beneficial to investors and entrepreneurs. For example, you might own 51% of common stock, but when you take into account anti-dilution rights, preemptive rights, adjustments to conversion rates, participating versus nonparticipating preferred, clawback's, vesting schedules and other parameters, it's very hard to know what your share of the ultimate pie might be. Furthermore, owning 51% of the fully diluted common stock does not guarantee control. With the VC investment will come new board members, and rights to take control of the board if the company misses milestones. That's not to say percentage is not relevant, just that it's not simple. All things being equal, (which never happens), a higher percentage is better than a lower one, but when the bargaining starts it is easy to make too much of that.

Entrepreneurs need to keep in mind that the fundamental economics of venture capital funds constrain VCs in setting the terms and size of their investments. Based on the size of the fund, they have to allocate a certain amount of money to initial investments, another chunk to follow-on investments in successful companies, and still a third for “problem children” i.e., the companies that still show promise, but can’t seem to keep momentum. The size of the VC fund’s staff is also a factor. There are only so many deals that one person can successfully monitor, manage and contribute to. Remember part of what you are getting with the venture capital money is the knowledge and experience of the fund principals. If your contact with the venture fund has too many pots to watch, you may not get your full measure of advice.

The net effect of all these factors is that venture funds typically invest from one to five million dollars in an early round, and generally receive anywhere from 25 to 75% of the equity of the company on a fully diluted basis, that is, assuming all options, conversion rights and other equity interests are fully exercised. However, even if you maintain 51% of this magic fully diluted number, if your company does not perform, there will undoubtedly be adjustments or subsequent rounds of financing that might dilute you down to single digits.

And single digits aren’t necessarily all that bad either. If your share declines because of follow-on investment rounds at increasing prices, then the value of your seemingly small 9%, may far exceed the value of 90% of an earlier round. Just remember, it’s all about the money. I doubt Bill Gates thinks about what his percentage of Microsoft was when he first received venture capital money. All he really cares about is what it’s worth right now.

Our [Virginia and North Carolina business lawyers] know quite a bit about how ownership agreements and funding structures work. Use the comments below to share your observations and questions about ownership in your start-up company.