

NO PAIN – NO GAIN: Five Arguments Not to Have With Your Mezzanine & Late Round VC

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For life sciences companies, multiple rounds of institutional financing are an ordinary part of the growth and financing cycle. Even the relatively recent alternative business models which look to shorten the time to market and the cost of the clinic anticipate two or even three rounds of institutional money in support of the smorgasbord of grants, partners, strategic investors and angels that serve as the primordial soup of this space.

For young companies, these later rounds can often become exercises in pain management, as the growing number of constituencies within the company -- founders, scientists, early partners (including academic partners), professional executive management and prior round investors -- come together in a financial donnybrook that can lose sight of the primary point of the exercise, which is to fund the continued growth of the company.

One of the critical tools for company management at this time -- besides the 500-tablet bottle of acetaminophen -- is a view of the market that allows them to pick battles sensibly. To this end we have provided below a short list of terms that too often cost more energy than they should due to misunderstanding of the state of the market, the purpose of the protection or its value to the company and investors.



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Pay to Play

These provisions, which penalize investors who refuse to participate in later rounds with loss of rights (ranging from loss of preference to loss of voting rights or board representation), have become increasingly common. Oddly, management often sits out this fight viewing it as an intra-investor battle. However, there can be real value to the company in forcing investors to lead, follow or get out of the way. These provisions can help prune the investor group, keeping those investors who can best support the financial needs of the company in leading roles. They can also help create a controlling investor group with sufficient "dry powder" to cover unexpected additional cash needs, as well as helping to avoid hold ups or break deadlocks. The company should carefully analyze its investor group and ask counsel to help craft important exemptions in order to get the issues on the table early and use these provisions to optimize its capital structure.

Board Composition

How much is too much? As the investor group grows, it is too often true that the board increases in size and, almost by definition, decreases in effectiveness. Keeping the board at a manageable and effective level of five to nine voting members is a task that needs to begin in early rounds, with the understanding that early investors will surrender part of their stake to later, that founders will give way to professional executive management and that strategic investors will have observer status. Pay to play can help in this area as non-funding investors can be reduced to observer status or even unseated entirely. Judicious use of observer and information rights can be helpful in getting minority investors and management to accept that voting rights as one of seven or nine are not overly valuable and that having access to information can be a useful compromise.

Reverse Vesting

One of the most difficult issues to overcome is the Brehznev Doctrine of founders -- "What we have we hold." Founders whose role in the company is nearing its end but who retain an inordinately high percentage of equity can create a dramatic mismatch in incentives and leave little room for equity rewards for sorely needed professional management. Educating founders early about the market standard in this area, as well as about the difference between cash contributions and other contributions, is critical to diffusing this issue.

Change of Control

If reverse vesting is the bug in the ear for founders, these provisions are the same for management. There is no doubt that double triggers are the market standard and that serious money will simply not accept anything less. Not only will intransigence here get the relationship off to a rocky start, it will cost management leverage in negotiating bonus plan upon sale, which is likely to be far more important and attainable.

Drag Along Rights

Not only are these provisions market terms, the company should rightly view them as useful. As long as reasonable standards (such as board approval or majority of independent directors) are included, a drag is helpful to completion of an exit that can benefit all classes, making the transaction less costly and avoiding hold outs that delay or kill a deal.

While each deal has its own unique problems and issues, the company and management team that understands and applies foresight and preparation on the issues discussed above can remove significant road blocks to closing its serial financing rounds.

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