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Trust and Control: The Value Effect of Venture Capital Term Sheet Provisions as Risk Allocation Tools

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TRUST AND CONTROL: THE VALUE EFFECT OF VENTURE CAPITAL TERM SHEET PROVISIONS AS RISK ALLOCATION TOOLS

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Abstract

The parties to a venture funding agreement are in a state of coopetition. The parties account for perceived risk in the entrepreneur-investor relationship through varying levels of control demanded from and trust afforded to the other party. The level of risk perceived by each party may differ along individual aspects of the prospective equity deal. The provisions of the term sheet delineate the subjective risk perceptions of each party to the transaction by allocating control or trusting a party with decision-making rights. When negotiating term sheet provisions, a party should seek to understand and recognize the risk perceived by the other party and attempt to afford the level of control or trust necessary to achieve a relational agreement that provides the greatest value for the parties collectively. An optimal allocation of control and trust adequately captures the perceived risk of each party, promotes cooperation between the parties, and ultimately facilitates the performance of the business venture. Understanding the subjective risk perceptions of each party to the investment transaction will facilitate the objective of negotiating a term sheet that maximizes the value created for all parties.

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Introduction

In the venture capital community, it is a well-known yet under-reported fact that the relationships between investors and entrepreneurs often turn sour and may even lead to litigation. At the heart of this tension are conflicting interests between investors and entrepreneurs that lie in conflicting risk perceptions, access to information, and the desire to control the venture to minimize any negative fallout arising from this delicate business relationship.

Take the case of San Francisco-based Rapt, Inc. Several of Rapt's co-founders threated to leave the company after a falling out with the company's Chief Executive Officer (CEO).[1] The company's venture capital investors took negatively to this decision and exercised their right to dilute the departing founders' common stock through a subsequent round of equity financing.[2] After the investors diluted the stock, the departing co-founders commenced litigation against the venture capitalists.[3]

Start-up ventures such as Rapt often depend heavily upon outside capital during the growth stages of their business lifecycle.[4] The sale of equity, which is a primary source of business capital for rapidly growing busi-

1. *Will Accel and Levensohn Get Rapt?*, Thompson Financial Private Equity Week (Sept. 6, 2006) http://hosting.mansellgroup.net/enablemail/ThomsonNewLetter/HostedWires/NewsLetters/Sept6-06.htm.

2. *Id.*

3. *Id.*

4. *See* Albert V. Bruno & T. Tyebjee, *The Entrepreneur's Search for Capital*, 1 J. Bus. Venturing 61, 61–74 (1986).

nesses, entails inherent risks for both the investor and the entrepreneur.[5] Risk is defined in this context as the likelihood that the start-up's business activity will lead to undesirable results for either the venture capital investor or the entrepreneur.[6] Each party will, therefore, seek to allocate risk to protect against her own interest.[7] Within an equity funding transaction, the parties negotiate the allocation of risk through the use of a term sheet, a non-binding document containing the most important and agreed upon equity financing terms.[8]

This Article will examine the use of term sheets to allocate specific elements of each party's perceived risk. The allocation of risk is characterized by the amount of control attributed to each party contrasted with the level of trust between the parties.[9] In an ideal relationship with complete trust and information, the parties would agree on minimal control provisions. However, given that information asymmetries exist and the parties to a venture capital investment often do not know each other and therefore lack a basis for trust, the control terms negotiated in a term sheet serve as important risk mitigation tools for each party in a scenario best characterized as coopetition. Coopetition refers to a scenario in which parties both compete for resources and cooperate to achieve strategic long-term goals.[10]

This Article proceeds as follows. Part I reviews the need for equity funding in start-up ventures and the competing interests or expectations between the investor and the entrepreneur. Part II explores the inherent risk associated with start-up ventures; the perception of risk and its effect on decision making; and the role of cooperation, trust, and control provisions in the allocation of risk. Part III addresses the risk allocation between investor and entrepreneur by focusing on business valuation, timing of funding, and the individual risk allocation components of the term sheet. A central claim of this Article is that the level of trust between the parties impacts the risk perceived by each party. Levels of risk and trust motivate the varying levels of control allocated to each party through a venture capital term sheet. The desire for control is an important aspect to understand because it affects the level of cooperation between the par-

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5. Raphael Amit et al., *Entrepreneurial Ability, Venture Investments, and Risk Sharing*, 36 Mgmt. Sci. 1233, 1233 (1990).

6. Terje Aven & Ortwin Renn, *On Risk Defined as an Event Where the Outcome is Uncertain*, 12 J. Risk Res. 1, 1–11 (2009).

7. *See* Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 Rand J. Economics 57, 57–76 (1998).

8. Dirk De Clercq et al., *An Entrepreneur's Guide to the Venture Capital Galaxy*, Acad. Mgmt. Persp., Aug. 2006, at 90, 99–100.

9. *See* Tushar Kanti Das & Bing-Sheng Teng, *Trust, Control, and Risk in Strategic Alliances: An Integrated Framework*, 22 Organization Stud. 251, 251–85 (2001).

10. *See* Xueming Luo et al., *Cross-Functional "Coopetition": The Simultaneous Role of Cooperation and Competition Within Firms*, 70 J. Marketing 67, 68 (2006) (discussing how coopetition occurs whenever there is a mixture of competitive and cooperative behaviors, which may include such diverse business settings as departments, business units, or firms).

ties. Part IV addresses the value effect of the allocation of control provisions to facilitate a relational contract and discusses the implications for further research in the area of risk perception in the effective allocation of control in the entrepreneur-investor relationship. Part V concludes by asserting that the cooperation between stakeholders facilitated by awareness in the negotiation of control provisions leads to improved organizational performance of the start-up venture.

I. The Role of Equity Investment in Start-up Ventures

Equity funding is a critical component in the development of entrepreneurial ventures.[11] This type of funding may be the best or only available option for many start-up ventures. Part I explores the role of venture capital in the start-up venture, providing an overview of the equity funding process and outlining each party's objectives.

A. *Start-up Ventures and Their Need for Capital*

Entrepreneurship is commonly understood as the founding or running of a business. A more precise definition of entrepreneurship focuses on the planning and assembling of resources necessary to bring about a venture.[12] Pursuant to this definition, entrepreneurs assemble resources around a venture concept to create a business that produces the type and amount of desired value.[13] The resources necessary to bring about the business consist of human and physical capital. Human capital comprises the entrepreneur's skill, intellect, and relationship capital. Physical capital, often associated with investors, comprises the assets or funds necessary to assemble and employ any required assets in addition to what the entrepreneurs may contribute.[14]

The amount of physical capital required by a growth-oriented start-up venture is often large and beyond the financial means of the entrepreneurs. Entrepreneurs often need to employ alternative funding strategies to acquire this necessary capital, which include personal or business debt arrangements and the sale of ownership or equity interest in the prospective business venture.[15] The funding strategy employed by an entrepreneur is limited by the financing options available; however, it also depends

11. Harry J. Sapienza & Jeffry A. Timmons, *The Role of Venture Capitalists in New Ventures: What Determines their Importance?* Acad. Mgmt. Proc., Aug. 1989, at 74.

12. *See generally* Sharon A. Alvarez & Lowell W. Busenitz, *The Entrepreneurship of Resource-based Theory*, 27 J. Management 755, 755–75 (2001).

13. *See* David B. Audretsch & Max Keilbach, *Does Entrepreneurship Capital Matter?*, 28 Entrepreneurship Theory & Prac. 419, 419–429 (2004); Per Davidsson, & Benson Honig, *The Role of Social and Human Capital Among Nascent Entrepreneurs*, 18 J. Bus. Venturing 301, 301–31 (2003).

14. Audretsch & Keilbach, *supra* note 13, at 419.

15. Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. Banking & Fin. 613, 618–21 (1998).

upon her intent, objectives, or aspirations (collectively, referred to in this Article as objectives) for the business.[16] This Article focuses on the decision to seek venture capital from third-party equity investors—referred to generally as a private placement of equity.

Equity investment by venture capital investors is a primary source of funds needed to scale a venture's product or services.[17] It provides the physical capital necessary to commence and grow operations.[18] For purposes of this Article, we define equity investment as early stage growth funds provided by venture capital firms. This definition includes investments that exceed amounts typically offered by individual angel investors[19] and are less than those offered by large private equity firms.[20] Aside from the financial necessities of the firm, a private placement of equity may offer secondary benefits for the business venture.[21] For example, equity investors may offer human capital in the form of advice to the entrepreneur, an infrastructure of resource providers (such as accounting, law, and public relations) to the business,[22] and an augmented reputation of the venture within the market.[23] These and numerous other benefits

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16. The capital structure of the firm varies with the characteristics of the firm. *Id*. at 660. The objectives for growth and the stage of business development therefore affect the funding structure employed by the entrepreneur.

17. *See* Antonio Davila et al., *Venture Capital Financing and the Growth of Startup Firms*, 18 J. Bus. Venturing 689, 689–708 (2003).

18. Berger & Udell, *supra* note 15, at 622. Within the business plan, capital is typically broken into start-up and working capital. Working capital generally accounts for the funds necessary to grow the venture in accordance with the financial projections.

19. *See* Andrew Burke et al., *What Determines the Level of Informal Venture Finance Investment? Market Clearing Forces and Gender Effects*, 42 Small Bus. Econ. 467, 473–74 (2014) (summarizing descriptive statistics taken from surveys of early-stage investments).

20. *See* M. Sinan Goktan & Erdem Ucar, *Public vs. Private: Characteristics of the Companies Backed by Listed Private Equity*, 12(5) J. Acct. & Fin., Dec. 2012, at 11–25.

21. Charles J. Cuny & Eli Talmor, The Staging of Venture Capital Financing: Milestone vs. Rounds 2 (Apr. 2005) (EFA 2005 Moscow Meetings Paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=487414 (citing William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. Fin. Econ. 473 (1990); Josh Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. Fin. 301 (1995) (regarding "the dual role of venture capitalists and their involvement in monitoring and governance")); *see also* Thomas Hellmann & Manju Puri, *The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital*, 13 Rev. Fin. Stud. 959, 959–84 (2000); Thomas Hellmann & Manju Puri, *Venture Capital and the Professionalization of Start-up Firms: Empirical Evidence*, 57 J. Finance 169, 169–97 (2002) (providing empirical evidence of the economic value of in-kind services provided to the business venture by investors).

22. Davila et al., *supra* note 17, at 691–93 ("[Venture capitalists] also bring a network of contacts with experienced infrastructure providers (such accounting firms, law firms, and public relations firms) and potential professional managers.").

23. *See id.* (suggesting that associating with a venture capitalist investor yields an advantage in attracting high quality employees, gaining new customers, and negotiating alliances and joint ventures with key players).

provided by venture capitalists drive growth, a primary objective of start-up ventures.[24]

B. *Overview of the Equity Investment Transactional Process*

The venture capital funding transaction generally adheres to a common model. First, the potential investor reviews the entrepreneur's business plan and conducts an informational interview with the entrepreneur. Next, the potential investor and the entrepreneur engage in preliminary negotiations regarding the potential purchase of business equity. The parties then create a finalized term sheet that outlines the major provisions of the proposed equity deal, and the equity investors conducts due diligence for a specified period. Following due diligence, the parties negotiate the purchase agreement and collateral documents, complete necessary regulatory filings, and, finally, consummate the exchange of equity for capital.[25] Any of these steps may be absent or vary considerably depending on the individual funding deal, but these steps provide a baseline for understanding the major steps in the equity investment transaction process.

The term sheet negotiation phase of the transaction is a pivotal point in which individual cognition affects the immediate relationship between the parties and the long-term characteristics of the start-up venture. Term sheet negotiations begin once the investor and entrepreneur are serious about consummating an equity investment deal.[26] At this point during the negotiation process, the entrepreneur and investor discuss the major issues affecting the transaction.[27] Both parties want to be certain that there is a meeting of the minds before committing further resources, entering a legally binding relationship, and undertaking further due diligence.[28] The results of the negotiation phase are reduced to a number of general provisions within the term sheet. While the term sheet is generally not binding, these terms provide the foundation for the agreement.[29] Once these terms are decided, they are rarely changed at a later stage of the transaction.

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24. *See id.* (suggesting that equity financing drives the growth of start-up ventures).

25. *See* De Clercq et al., *supra* note 8, at 98–100.

26. *Id.* at 99 ("Thus, terms that are deal breakers are identified and negotiated before either side gets too far into the process. The result of this negotiation is a written document, commonly referred to as the 'term sheet.'").

27. *Id.* at 99–100 ("[The term sheet] summarizes the major terms of the potential [venture capitalist] investment. If the outcome of the due diligence process is favorable, then the venture capitalist will make an investment subject to the terms outlined in the term sheet. The actual closing of the investment transaction requires a plethora of detailed legal documents that are negotiated in detail at the end of the selection process.").

28. *Id.* at 99 ("Since the evaluation process is time-consuming for both parties, it is common to negotiate the major terms of the deal before the [venture capitalist] starts extensive due diligence.").

29. *Id.* at 100 ("While the term sheet is not binding on any party, it is unusual for 'deal breakers' to arise when the final legal documents are drafted.").

Each party then depends upon counsel in drafting, negotiating, and finalizing these and other ancillary terms of the agreement.[30]

C. *The Entrepreneur's and Investor's Objectives*

A unique tension exists in the entrepreneur and venture capitalist relationship that can be attributed in part to the parties' conflicting goals. This Section examines the common and at times conflicting objectives between these two parties.

1. The Entrepreneur's Objectives

In a start-up venture, the entrepreneur seeks to assemble the resources necessary to grow the venture as quickly as possible without regard to immediate profitability.[31] She does not depend upon the venture to provide for or fund the entrepreneur's lifestyle; rather, she will generally take a meager or no salary in the early stages of the business venture.[32] Most, if not all, of the business earnings are reinvested in the business to increase the speed of business growth.[33] Rather than look to the earnings of the business to provide for her living expenses, the entrepreneur hopes to extract value from the business at some future exit event, such as a sale of the business.[34] The concept behind this type of venture is that the most efficient use of any funds generated by the business is growing and creating additional value within the business.[35]

The earnings generated by the business activity, however, are rarely sufficient to provide the funds necessary to achieve the potential business growth.[36] The start-up entrepreneur, absent other means of access to funding, must seek outside sources of capital to fund the business activity's growth. The business' growth projections, which may include the scalability of the business' product or service, are a primary concern of equity investors, who seek investments with high growth potential.[37]

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30. *Id.* ("Because many of the term sheet issues have been difficult and emotional, often the details of closing are handled by the parties' lawyers with little direct involvement from either entrepreneur or [venture capitalist].").

31. *See* Martin Przysuski et al., *What Operating Losses Tell Us*, 5 Corp. Bus. Tax'n Monthly 1, 2–3 (2003) (explaining "startup losses" as necessary at certain stages of the business venture).

32. Robert D. Hall & Susan E. Woodward, *The Burden of the Nondiversifiable Risk of Entrepreneurship*, 100 Am. Econ. Rev. 1163, 1163–64 (2010), *available at* http://web.stanford.edu/~rehall/Hall-Woodward%20on%20entrepreneurship.pdf.

33. *See* Seppo Leminen & Mika Westerlund, *Categorizing the Growth Strategies of Small Firms*, Tech. Innovation Mgmt. Rev., May 2012, at 5, *available at* http://timreview.ca/sites/default/files/article_PDF/LeminenWesterlund_TIMReview_May2012_0.pdf (linking growth strategies with use of capital inside the firm).

34. *See* Hall & Woodward, *supra* note 32, at 1163–64.

35. *Id.*

36. *See* Seppo Leminen & Mika Westerlund *supra* note 33, at 8.

37. John Hall & Charles W. Hofer, *Venture Capitalists' Decision Criteria in New Venture Evaluation*, 8 J. Bus. Venturing 25, 25–42 (1993).

These projections, therefore, affect the type and amount of resources available to the entrepreneur to fund the business venture.

An important objective of most entrepreneurs is to retain as much control and ownership as possible throughout the life of the enterprise. The tension between an investor and entrepreneur about eventual control of the enterprise is plays a central role in the investment negotiations. According to one study, fewer than 25% of founders led the initial public offering of the business they started.[38] According to that same study, four out of every five founders are forced to step down as CEOs by equity investors and majority shareholders.[39] The decision or order to step aside from the top leadership position of a venture they initiated, which may have started out more as a labor of love, is a difficult and emotional event that founders seek to avoid. Sometimes, the founder may lack objectivity or a profit-seeking objective in their desire to retain control and leadership. According to research, entrepreneurs are typically convinced that they are the only ones who can lead their start-ups to success and they are typically overconfident about their prospects for success.[40] Both of these often inaccurate perceptions will lead a founder to seek as much control of the enterprise as possible, which may work to the detriment of investors.

2. The Investor's Objectives

In exchange for an ownership interest in the business, equity investors provide the funds necessary to grow the business venture.[41] As professional equity investors, venture capitalists typically organize as a partnership and obtain investment funds from limited partner investors.[42] The limited partnership is commonly referred to as the venture capital fund.[43] The venture capitalist, as general partner, manages and invests the funds in start-up ventures with the purpose of achieving a specific or target return on their investment.[44] The venture capital firm generally seeks a return on its individual investments within three to seven years from the time of investment.[45] This investment horizon is important because the capital in the fund, which consists of invested capital and any accrued re-

38. Noam Wasserman, *The Founder's Dilemma*, Harvard Bus. Rev., Feb. 2008, at 102, *available at* http://hbr.org/2008/02/the-founders-dilemma/ar/1.

39. *Id*.

40. *Id*.

41. Michael Gorman & William A. Sahlman, *What do Venture Capitalists Do?*, 4 J. Bus. Venturing 231, 231–48 (1989).

42. William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. Fin. Econ. 473, 473 (1990)

43. *Id.*

44. *See generally* Sophie Manigart et al., *Determinants of Required Return in Venture Capital Investments: A Five-Country Study*, 17 J. Bus. Venturing 291 (2002).

45. *Id.* at 300.

turns, is due to be returned to the limited partner investors within a specified period.[46]

The equity investor reviews business plans, searching for businesses that require growth funds and have the capacity to achieve a level of growth capable of producing a significant return on investment.[47] This means that the business must show potential to produce significant revenues and achieve a high valuation at an anticipated future exit event.[48] Inherent in any start-up venture is some degree of risk. As previously stated, risk is generally understood as the likelihood that the business activity will lead to undesirable results for either the investor or entrepreneur.[49] When deciding whether to invest in the venture, the investor will balance the required return on funds invested with the level of risk inherent in the investment.[50] This risk for the investor is based on the probability that the venture will provide the desired level of return within the stated investment period.[51] While the amount of risk involved in investing in a venture is necessarily a subjective determination, investors commonly use certain general factors to assess the level of risk. These factors include the stage of business growth, the experience or credentials of the founders, the current assets of the business, the business' apparent competitive advantage (such as having secure intellectual property), the intended use of funds, current business revenue, and existing service contracts.[52] Each factor either augments or diminishes the investor's confidence that the business will create the type and amount of value desired.

Another important objective for the equity investor is to maximize the potential for start-up success through effective corporate governance. As previously mentioned, most founders are removed from the CEO leader-

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46. D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. Rev. 315, 345 (2005) [hereinafter Smith, *Exit Structure*] (internal citation omitted) ("Exit is not merely optional for venture capitalists. Most venture capital funds have a fixed life, usually ten years with an option to extend for a period up to three years. Any venture capitalist who desires to remain in business, therefore, must successfully raise funds, invest them in portfolio companies, then exit the companies and return the proceeds to the fund investors, who in turn are expected to reinvest in a new fund formed by the same venture capitalist (assuming that the previous investment was successful."); *see also* Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. Fin. Econ. 3, 19 (1999) (stating that "almost all venture and buyout funds are designed to be "self-liquidating," that is, to dissolve after ten or twelve years[ ]").

47. *See* David Kirsch, Brent Goldfarb, & Azi Gera, *Form or Substance: The Role of Business Plans in Venture Capital Decision Making*, 30 Strategic Mgmt. J. 487 (2009) (discussing [venture capitalist] funding decisions).

48. *See id.*

49. *See* Aven & Renn, *supra* note 6.

50. Hall & Hofer, *Venture Capitalists' Decision, supra* note 37, at 38.

51. John G. Cochrane, *The Risk and Return of Venture Capital*, 75 J. Fin. Econ. 3, 28 (2005).

52. *See, e.g.*, John C. Ruhnka & John E. Young, *Some Hypotheses About Risk in Venture Capital Investing*, 6 J. Bus. Venturing 115 (1991) (describing a number of factors venture capital funds may consider when evaluating the risk of a possible investment).

ship position within a matter of a few years following a venture capitalist equity investment. This occurs because the equity investors typically gain majority ownership and control of the start-up in exchange for their equity investment. As a start-up matures and grows, its need for an experienced business leader increases and the role of the board at that point is to replace the founder with a CEO with a broader managerial and leadership skill set.

II. Risk: Perception, Decision Making, and Control

A. *Risk and Uncertainty in Entrepreneurial Ventures*

Undertaking or investing in entrepreneurial ventures is statistically risky—approximately 50% of U.S.-based new ventures fail within 5 years and 75% of businesses fail within 20 years.[53] The success or failure rate for new ventures, however, is only one aspect of risk. A broader view of risk focuses on uncertainty or the possibility of occurrences that can thwart the intent of the parties involved in the entrepreneurial venture.[54] For example, an investor's view of venture risk might include the possibility that the business will fail to reach its growth goals and yield a subpar return. The entrepreneur's view of risk may include a loss of control or a deviation from the start-up's mission or ethos. These examples serve only to demonstrate the various and unique types of risk that exist beyond the broad categorization of success or failure. This is important for understanding the tension in the entrepreneur-investor relationship because the level of risk perceived by a party to an equity transaction may depend on the type of risk perceived.

While entrepreneur and investor may perceive different types of risk, all risk is based on uncertainty.[55] Uncertainty regarding any aspect of the business or the market itself represents a unique form of risk to the individuals involved in the business.[56] Market-demand uncertainty, for example, exists when an investor and entrepreneur have different levels of certainty regarding the ability of the business to achieve its goals based on the manner in which the market receives the business.[57] Ability uncertainty, on the other hand, consists of each party's level of certainty about

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53. *Business Employment Dynamics, Entrepreneurship and the U.S. Economy*, U.S. Bureau Lab. Stat., http://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm (last visited July 13, 2015).

54. Brian Wu & Anne Marie Knott, *Entrepreneurial Risk and Market Entry*, 52 Mgmt. Sci. 1315, 1315 (2006) ("We believe that the disparity between intuition and theory versus the stylized facts lies in the dimensionality of uncertainty.").

55. *Id.* ("In particular, we propose that there are two distinct sources of uncertainty in entrepreneurial ventures: (1) uncertainty regarding market demand, and (2) uncertainty regarding one's own entrepreneurial ability.").

56. *See* Aven and Renn*, supra* note 6, at 6–9.

57. *See* Wu & Knott, *supra* note 54, at 1316–17.

the ability of the entrepreneur to lead the business.[58] These types of uncertainty, along with many other forms of identifiable risk, affect the parties' perception of venture risk and the total risk attributable to the venture.[59]

The level of risk that an individual associates with an activity is determined by how that individual perceives or cognitively processes the situation.[60] While risk involves the probability of a particular outcome, risk propensity regards an individual's propensity to act pursuant to that risk.[61] In other words, an individual will act according to the amount of perceived risk that she is willing to accept[62] and her actions or intended actions may vary depending upon how she perceives a given situation. Therefore, in an equity funding transaction, the entrepreneur and investor will consummate a funding deal if the perceived characteristics of the deal are consistent with their respective risk propensities. Unknowingly, the terms used to allocate risk in the venture, as expressed in the term sheet, may have a detrimental effect on the level of cooperation between the parties.

B. *Trust, Control and Cooperation*

According to social capital literature, trust is the subjective belief about the likelihood that a potential trading partner will act honestly or as expected.[63] A personalized level of trust is dependent upon the evolving

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58. Gavin Cassar, *Industry and Startup Experience on Entrepreneur Forecast Performance in New Firms*, 29 J. BUS. VENTURING 137–51 (2014) (examining the benefit of industry experience on entrepreneurial forecast performance).

59. Wu & Knott, *supra* note 54, at 1315, ("We further propose that entrepreneurs display risk aversion with respect to demand uncertainty but exhibit overconfidence or 'apparent risk seeking' with respect to ability uncertainty. Accordingly, while entrepreneurs are risk averse in the classic sense of preferring a certain payment to an uncertain payment with equivalent expected value, their overconfidence predisposes them to bear economic risk under a given set of circumstances.").

60. Saulo D. Barbosa et al., *The Role of Cognitive Style and Risk Preference on Entrepreneurial Self-efficacy and Entrepreneurial Intentions*, 13 J. LEADERSHIP & ORGANIZATIONAL STUD., May 2007, at 90 (citing Kenneth R. MacCrimmon & Donald A. Wehrung, *A Portfolio of Risk Measures*, 19 THEORY & DECISION 1, 1–29 (1985) (stating that cognition is the reason why situations look more or less risky); *see also* R. M. HOGARTH, JUDGMENT AND CHOICE: THE PSYCHOLOGY OF DECISION 13 (Wiley 2d ed., 1987) ("[F]rom a logical viewpoint, it is absurd to make a statement of the kind that one situation or venture is more uncertain than another; it is simply you who are more uncertain about one of the situations.").

61. *See* Sim B. Sitkin & Amy L. Pablo, *Reconceptualizing the Determinants of Risk Behavior*, 17 ACAD. MGMT. REV. 9, 18–19 (1992) (defining risk propensity as a general tendency or desire to either pursue or avoid risk); *see also* Barbosa et al., *supra* note 60, at 90 (citing MacCrimmon & Wehrung, *supra* note 60, at 1 ("Risk-taking has two components: the riskiness of situations and the willingness of people to take risks.")).

62. Barbosa et al., *supra* note 60, at 90 ("[R]isk preferences are by definition 'the willingness of people to take risks.'").

63. Laura Bottazzi et al., *The Importance of Trust for Investment: Evidence from Venture Capital* 1, (Nat'l Bureau of Econ. Research, Working Paper No. 16923, 2011).

relationship between two specific parties.[64] When a relational contract is maintained, personalized trust is present, as is the mutual trust that individuals develop through repeated experience and interactions.[65] The hallmarks of a relational contract include longer duration and greater personal interaction and cooperation between the contracting parties.[66] Discrete contractual transactions differ from relational contracts in some fundamental characteristics, including commencement, duration, termination, measurement and specificity, planning, sharing vs. dividing benefits and burdens, interdependence, future cooperation, solidarity, personal relations among participants, and power.[67] Venture capital term sheet provisions provide a good setting in which to measure the extent of relational contract because term sheet provisions often relate to the above mentioned characteristics and can vary in terms of their degree of contractual formality, control, and specificity.

The venture capital investment process provides an interesting setting to examine trust, the contracting process, and relational contracting. A venture capitalist and an entrepreneur typically do not know one another before contracting.[68] Yet, after they enter into a contract, venture capitalist and entrepreneur work closely together and have an opportunity to build trust over the course of their relationship.[69] Both parties are clearly incentivized to build trust and a relational contract. For example, the entrepreneur is interested in developing trust to avoid being diluted or shut out from the venture in a manner that is perceived as detrimental. An early investor participating in a Series A round of financing is incentivized to a greater extent to develop trust with an entrepreneur than investors that join during subsequent rounds of financing, such as investors in Series B, C, and D rounds of financing. For several reasons, the earliest round investor is incentivized to establish trust with the entrepreneur and build a relational contract as early as possible. First, the investor stands to benefit from subsequent rounds of financing if she develops trust and cooperation with the entrepreneur and, accordingly, prices that level of trust and cooperation into the original share valuations. Further, these early round in-

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64. *Id*. (contrasting personalized trust with generalized levels of trust, e.g. the trust that is necessary to invest in anonymous markets as a whole, such as stock markets); *see* Paola Sapienza, *Trust and Financial Markets, in* THE FIRST CREDIT MARKET TURMOIL OF THE 21ST CENTURY 29, 33 (Douglas D. Evanoff, Philipp Hartmann & George G. Kaufman eds., 2009).

65. *See* Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912, 916 (1994).

66. *See* IAN R. MACNEIL, CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS, 12–13 (2d ed. 1978); Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"*, 75 NW. U. L. REV. 1018, 1025 (1981).

67. *Id*.

68. Bottazzi et al., *The Importance of Trust*, *supra* note 63, at 5.

69. *Id*.

vestors may assume the role of reputational intermediaries with later round investors and be perceived as parties with an attractive deal flow because they are able to generate the greatest levels of cooperation and value among start-up companies. This status may send a signal to later stage investors who are interested in investing in companies that show high degrees of cooperation among the parties and who ultimately agree to invest at a premium given the reputational effect.

Capitalizing on the investor-entrepreneur relationship requires a level of cooperation between the parties that characterizes a relational contract. Cooperation, however, may conflict with the natural incentives of either party to seek greater personal benefit in the relationship to reduce their perceived risk.[70] For example, the entrepreneur may have incentives to withhold information[71] and to be uncooperative in the use of resources,[72] while the investor may have incentives to be uncooperative in the provision or disbursement of funds.[73] In other words, the entrepreneur may withhold necessary information from the investor or the investor may discount information provided by the entrepreneur as self-serving, particularly in the valuation of the business.[74] These conflicting incentives often break down the level of cooperation and communication between the parties and cause the parties to take adversarial positions, particularly during the earliest stages of the relationship.[75] Such an occurrence diminishes the value of human and physical capital provided by the investor and hurts the business venture over time.[76] As such, it is important to undertake mea-

70. *See generally* Dmitry Khanin & Ofir Turel, *Conflicts and Regrets in the Venture Capitalist–Entrepreneur Relationship*, J. SMALL BUS. MGMT. (forthcoming 2015), *available at* http://onlinelibrary.wiley.com/doi/10.1111/jsbm.12114/abstract.

71. *See* Harry J. Sapienza & M. Audrey Korsgaard, *Procedural Justice in Entrepreneur-Investor Relations*, 39 ACAD. MGMT. J. 544 (1996) (finding that entrepreneurs often have incentives to withhold or misrepresent information to the venture capitalists).

72. *See generally* Daniel M. Cable & Scott Shane, *A Prisoner's Dilemma Approach to Entrepreneur-Venture Capitalist Relationships*, 22 ACAD. MGMT. REV. 142 (1997) (demonstrating that entrepreneurs may begin to focus on other activities that motivate opportunism in the use of resources).

73. Dean A. Shepherd & Andrew Zacharakis, *The Venture Capitalist-Entrepreneur Relationship: Control, Trust and Confidence in Co-operative Behaviour,* 3 VENTURE CAP.: INT'L J. ENTREPRENEURIAL FIN. 129, 130 (2001) [hereinafter Shepard & Zackarakis] ("[Venture capitalists] typically do not receive a return on their investment until after the limited partners (those that invested in the [venture capital] fund) have received their return. Such an arrangement may tempt [venture capitalists] to harvest a venture (and obtain their profits) rather than reinvest in the venture's future products and development.") (internal citations omitted).

74. *Id.* at 129–130 ("While the information provided by entrepreneurs is typically discounted by [venture capitalists], investments of venture capital (including later stage funding) are directly related to the entrepreneur's initial projections . . . ."). (internal citations omitted)

75. *See generally* Cable & Shane, *supra* note 72.

76. *See* Harry J. Sapienza, *When Do Venture Capitalists Add Value?*, 7 J. BUS. VENTURING 9, 9–10 (1992) (discussing the value that venture capitalists add to start-up ventures).

sures to facilitate cooperation between investor and entrepreneur because cooperation benefits both parties.

Cooperation is facilitated by an optimal combination of control and trust in the investor-entrepreneur relationship.[77] That is, cooperation requires an understanding between the investor and the entrepreneur that is characterized either through trust in the other party to carry out an activity related to the business or through an allocation of control to one party over that particular activity or aspect of the business.[78] As an essential element of relational contract, trust entails one party offering support in the procedures used by another party, without the need for strict control mechanisms.[79] Control, in contrast, is characteristic of discrete contractual relations and regards the formalized authority centered in one of the parties, such as through detailed contractual arrangement and specificity.[80] In the investor-entrepreneur relationship, control is granted through contractual provisions outlining the rights, authority, and obligations of a party.[81] Trust, on the other hand, results from various attributes of the parties and the transaction, such as fit, fairness, commitment, and communication.[82] Each of these trust components requires a level of reciprocity between the parties whereby each party respects the decision-making ability and judgment of the other.[83]

Some research indicates that trust and control are substitutes,[84] observing that the award of additional control to a party may act as a substitute for trusting that party in the decision-making process. As such, for

77. Shepherd & Zacharakis, *supra* note 73, at 139–40.

78. *Id.* at 129 ("The entrepreneur and the [venture capitalist] need to balance the level of control and trust building mechanisms so that the optimal level of confidence in partner co-operation can be achieved.").

79. Sapienza & Korsgaard, *supra* note 71, at 547–68 (analyzing methods of building trust in a business investment relationship.).

80. *See* Todd R. Zenger et al., *Informal and Formal Organization in New Institutional Economics, in* The New Institutionalism in Strategic Management 14–15 (Paul Ingram & Brian S. Silverman eds., 2000) *available at* http://apps.olin.wustl.edu/faculty/zenger/advances6u.pdf.

81. *See* Hellmann, *supra* note 7, at 60 ("Control rights matter either because they allow one party to make a decision in the presence of conflict of interest or because they affect the threat points in any renegotiation. Control is important since it affects the noncontractible behavior of the two contracting parties.").

82. Shepherd & Zacharakis, *supra* note 73, at 135 ("[T]rust can be built by both parties in [a]relationship by: (1) signaling commitment and consistency; (2) being fair and just; (3) obtaining a good 'fit' with the partner; and (4) frequent and open communications.").

83. *See* W. E. Douglas Creed & Raymond E. Miles, *Trust in Organizations: A Conceptual Framework Linking Organizational Forms, Managerial Philosophies, and the Opportunity Costs of Controls*, *in* Trust in Organizations: Frontiers of Theory and Research 1638 (Roderick M. Kramer & Tom R. Tyler eds., 1996) (supporting reciprocity as an important element to building trust.).

84. Sim B. Sitkin & Nancy L. Roth, *Explaining the Limited Effectiveness of Legalistic "Remedies" for Trust/Distrust*, 4 Org. Sci. 367, 375–79 (1993); *see* Cable & Shane, *supra* note 75, at 162–63, 171.

each specific situation (or transaction) there is an optimal level of trust and control.[85] Other research indicates that trust and control are not perfect substitutes and that low levels of trust exist at low levels control.[86] In either event, a party's level of trust will affect the amount of control desired or demanded by the other party.[87] Inequity in the level of control afforded one party in turn affects the willingness of the parties to cooperate in the business relationship.

C. *Trust, Control, and Risk Mitigation*

Prior research demonstrates that equity investors often require extensive control rights that exceed the value of their equity investment to the firm.[88] These scenarios defeat the objective of establishing a relational contract. The use of control to dictate decision making in an equity transaction introduces yet another type of risk known as agency risk. Agency risk is the possibility that either party may act in their own interest to the detriment of the other party's interests.[89] Agency theory focuses on a controlled (often contractual) agency relationship to combat these incentives.[90] Pursuant to this view, the entrepreneur is an agent of the start-up and investor shareholders and acts on their behalf when managing the business venture. The investor is drawn to an agency-based view of the relationship and accordingly may seek contractual provisions supporting this view in an attempt to control the entrepreneur's activities and reduce opportunism.[91]

Given the relationship conflicts inherent in extensive control scenarios, the efficacy of such an approach is uncertain, particularly as it pertains to

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85. Shepherd & Zacharakis, *supra* note 73, at 139, ("It seems that there is some optimal level of control that will allow trust in the relationship to develop and thereby generate the maximum level of confidence in partner co-operation and the level of trust influences the choice of control.").

86. *Id.* ("There is a curvilinear relationship such that at low levels of control there will be low levels of trust.").

87. *Id*. ("It is proposed that an assessment of one's current level of trust is likely to directly influence the choice and magnitude of the control mechanisms implemented. In this way the assessment of trust can act as a feedback mechanism informing the control decision in order to fine tune the combination of trust and control towards an optimal level of confidence in partner co-operation.").

88. *See* Andrei A. Kirilenko, *Valuation and Control in Venture Finance*, 56 J. FIN. 565 (2001)

89. Shepherd & Zacharakis, *supra* note 73, at 132 (citing James O. Fiet, *Reliance Upon Informants in the Venture Capital Industry*, 10 J. BUS. VENTURING 195 (1995) ("Agency risk is the degree of uncertainty that either the entrepreneur or the [venture capitalist] will pursue his or her own self interests rather than comply with the requirements of the contract for venture capital.").

90. *Id.*

91. *Id.* at 133 ("Agency theorists have provided valuable advice to [venture capitalists] and implement control mechanisms to ensure that the entrepreneur does not act opportunistically to the [venture capitalist's] detriment.")

building trust between the parties.[92] Attempting to mitigate a known risk precipitates a discrete contractual relationship that may ultimately augment risk resulting from a lack of cooperation. As an agent, the entrepreneur may feel subordinated and, perhaps, unduly beholden to the investor. The entrepreneur endures the risk of inequitable decision making by the principal (investor), such as removal as company CEO or dilution allowed by control terms negotiated by the investor. Relying on trust, on the other hand, to dictate decision making in the venture transaction likewise engenders an element of risk.[93] The actions of either party, such as behavioral inconsistency, lack of communication or forthrightness, inequitable conduct, or unwillingness to adjust to accommodate the other's needs, erodes any trust.[94]

As indicated, the conflicting risk perceptions between parties could result in disequilibrium that leads to a failed equity investment or an increased probability of undesired business performance. For example, during the initial contracting stage, characterized by low ex ante levels of trust, the venture capitalist will negotiate for high control terms in an early round of financing. The entrepreneur may perceive this high degree of control as a lack of confidence or opportunistic behavior by the investor. In turn, the parties may allow for contractual provisions that somewhat offset the extensive control provisions. One commonly used technique for overcoming this limitation, which is discussed in greater detail below, is to schedule the investment as a series of financing rounds that are contingent upon certain metrics or milestones. The earliest stages of venture capital financing in this model occur during Series A financing rounds, with subsequent rounds labeled Series B, C, D, and so on until the occurrence of a liquidation event, such as the sale of the business or an initial public offering.

Under the authors' conceptual framework, the subjective risk perceptions of each party are taken as a given at the earliest stages of financing, for example, during Series A financing. Risk is mitigated by each party's level of trust in the other, which in the initial round of financing is minimal. Unwittingly, given this low level of trust, the parties may be prone to bargain for the greatest control terms to protect themselves against their subjective perceived risk. One of three general scenarios will then result. The first scenario is that the entrepreneur will forego control because capital is required to grow the business and a business failure would ensue without the infusion of equity capital. The result of the first scenario will be a relationship with low levels of trust and highest chances of both entrepreneur and investor opportunism. The second scenario is that the entrepreneur will dig in her heels and refuse to grant control while taking into

92. *See* Cable & Shane, *supra* note 75.

93. Shepherd & Zacharakis, *supra* note 73, at 135 ("Implicit in the emergence of trust using this definition, is the necessary inclusion of some form of risk (perceived probability of loss).").

94. *Id.* at 135–37.

consideration the high likelihood of failure. The second scenario will likely result in failure to obtain equity financing. The third scenario is that the sophisticated serial equity investor will make some minor concessions to the entrepreneur in the form of contingent control terms. This third scenario may allay the entrepreneur's perceived risks and allow the parties to build relational contract that encourage increased trust during subsequent rounds of financing. Ideally, term sheet provisions should be structured in a manner to accommodate this third scenario.

Figure 1 below provides a visual depiction of the constructs and their relationships under the authors' proposed conceptual model. From this theoretical vantage point, any term sheet negotiations that yield the result of the third scenario will provide the best outcome among the three possible scenarios because it will lead to the best chance of building trust and a relational contract among the parties and the greatest likelihood of cooperation, which will in the long term outweigh the concessions made by the venture capitalist to the entrepreneur.

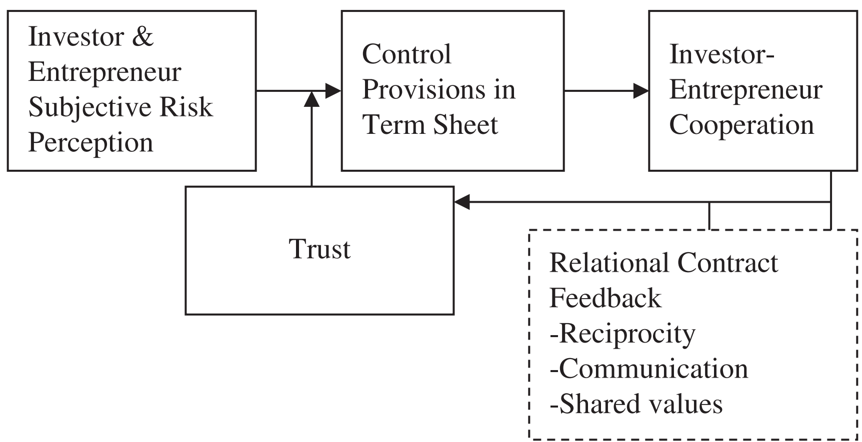

Figure 1. Trust-Building Conceptual Model During Venture Capital Equity Financing

III. Risk-Allocation terms

As introduced above, the level of control demanded and trust afforded the other party directly affects cooperation between the entrepreneur and investor. In this pseudo-competitive and cooperative state known as coopetition, the amount of control asserted by any party is directly related to the risk perceived in the business venture.[95] This Section explores the allocation of control between the entrepreneur and investor through the examination of select term sheet provisions. Each term sheet provision

95. Tobias Kollmann et al., *Trust and Controllability in Venture Capital Fundraising*, 67 J. Bus. Res. 2411, 2411 (2014) ("Results suggest that trust and perceived controllability shape the investment decisions of those LPs.").

identifies a type of perceived risk and the opportunity for one party to allocate control or afford trust to the other party.[96] The presence of control provisions therefore affects the level of cooperation between the parties and, ultimately, influences relative value created through the ongoing relationship. These provisions demonstrate the applicability of the proposed conceptual model by focusing on interplay of trust and control in the negotiation of each provision.

A. *Price of Equity (Valuation)*

Equity investors seek a return on their investment through a future exit event.[97] Unlike a large company investor who seeks a routine dividend,[98] the start-up equity investor seeks to earn a return on her investment at a point in the future when the equity of the business is sold.[99] For example, the investor may envision recouping her investment and earning a profit by selling her equity investment to a future round of investors, selling it back to the business, or selling it to public investors through an initial public offering of the business' stock.[100] Therefore, equity investors will only invest in a business that has potential to achieve a certain terminal value.[101] The terminal value must be sufficient to compensate the investor for the risk incurred for investing in the business.[102]

The amount of money an investor is willing to invest depends greatly upon the present valuation attributed to the business.[103] Present valua-

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96. *See* Yixi Ning, et al., *The Driving Forces of Venture Capital Investments*, 44 Small Bus. Econ. 315 (2014) (providing background reading on the macroeconomic and market factors (risk factors) affecting venture capital investment decisions).

97. De Clercq, et al., *supra* note 8, at 92 ("The preferential exit mechanisms for the [venture capitalist] are an initial public offering (IPO) and trade sale. The route to exit is preferably planned before the investment is made.").

98. *See generally*, Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares,* 34 J. Bus. 411 (1961) (providing a detailed analysis of the effect and drivers of dividend policies of corporate firms).

99. De Clercq et al., *supra* note 8, at 95 ("The [venture capitalists'] goal in the pre-investment phase is to make an investment in a venture that offers the potential for significant long-term capital gains . . . and offer[s] an exit opportunity in three to seven years after the investment.") (internal citations omitted).

100. Smith, *Exit Structure*, *supra* note 46, at 317 ("Exit may be accomplished through the sale or distribution of the venture capitalist's shares during or after an initial public offering (IPO) or acquisition of the portfolio company by another company. The portfolio company may also redeem the shares of the venture capitalist on demand pursuant to a contractual put right. Or, the venture capitalist may receive a cash distribution upon the liquidation of the portfolio company.") (internal citations omitted).

101. De Clercq et al., *supra* note 8, at 95 ("The [venture capitalists'] . . . target rates of return are about 30 to 60 percent per annum . . . and offer an exit opportunity in three to seven years after the investment.") (internal citations omitted); Avi Messica, *The Valuation of Cash-Flowless High-Risk Ventures*, 11 J. Priv. Equity 43, 43 (2008).

102. *See* Jonathan B. Berk et al., *Valuation and Return Dynamics of New Ventures*, 17 Rev. Fin. Stud. 1 (2004) (proposing a model capturing the sources of risk in determining the value and risk premium of the venture).

103. Messica, *supra* note 101, at 43–48.

tion is split into two categories: pre-money valuation and post-money valuation.[104] The pre-money valuation is the value attributed to the firm prior to infusing any new capital.[105] The post-money valuation is the value of the firm immediately following the infusion of capital.[106] Dividing the amount of money invested in the business by the post-money valuation generally results in the percentage of the business that the investor will own following the investment, often referred to as the investor's equity interest.[107]

Post-Money Valuation = Pre-Money Valuation + Invested Capital
% Investor Equity Ownership = Invested Capital / Post-Money Valuation

The question then becomes: how do the entrepreneur and investor arrive at an appropriate value or percentage of business equity to exchange for the investor's funds? Historically, investors have used a litany of different methods to value a business, including industry or transaction comparables, a net present value calculation, an adjusted present value calculation, or the venture capital method.[108]

The aptly named venture capital method is the most common method used in the angel and venture capital investment industry.[109] This method employs future cash flow projections and industry multiples to arrive at the value of the business at a future point in time, namely the time of exit.[110] The investor then uses the amount of the proposed investment and the perceived risk of the investment to determine the amount of return required for the investment.[111] The amount of return required by the investor divided by the value of the business at the time of exit is equal to the percentage of the business that the investor will require for her investment.[112] Once the investor and entrepreneur agree on a projected valuation for the business at the intended time of exit, the negotiation begins to determine the purchase price per share.[113]

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104. Paul Gompers, & Josh Lerner, The Venture Capital Cycle 90-91 (MIT Press, 2d ed., 2004).

105. *See id*.

106. *See id*.

107. *See id.*

108. *Id.* at 92 (listing investment valuation techniques and the positive and negative attributes of each); *see also* Messica, *supra* note 101, at 45–48 (explaining common valuation methods).

109. Messica, *supra* note 101, at 105.

110. *Id*.

111. *Id*.

112. *Id*. at 106.

113. *See* Robert H. Keeley, Sanjeev Punjabi, & Lassaad Turki, *Valuation of Early-stage Ventures: Option Valuation Models vs. Traditional Approaches*, 5 J. Entrepreneurial Fin. 115, 121 (1996), (explaining the venture capital method and the determination of purchase price per share based upon the desired percentage ownership of the company).

Investors normally seek a return equal to some multiple of their initial investment[114] or seek to achieve a specific internal rate of return based upon the level of perceived risk.[115] The riskier the investment, the greater the return the investor will seek. The valuation attributed to a business and the amount of equity offered in exchange for funds by each side is directly related to the amount of risk that the party perceives in the business venture.[116] That is, the investor will seek a rate of return from the investment consistent with her perceived risk in the failure or underperformance of the venture. Uncertainty about the characteristics of the entrepreneurial venture affects the valuation and magnifies the risk associated with the valuation method.

Conflicting valuations can diminish trust between the parties.[117] In a situation where parties hope to agree on a valuation, uncertainty by either party gives rise to a perception of risk and necessitates a higher level of control to diminish that risk. The investor hopes to achieve the results predicted by the entrepreneur, but benefits at this stage of negotiation from asserting a lower performance by the venture through a lower valuation. This state of coopetition may cause the investor to place greater weight on individual risk factors when attributing a valuation to the business. These competing interests play out as control or trust in the entrepreneur-investor relationship.

A lower valuation is effectively a control provision that reduces the likelihood of financial loss in the venture.[118] Trust in the entrepreneur's valuation, however, demonstrates less concern for existing risk factors and may result in a higher pre-money valuation of the business venture.[119] In either case, the amount of money invested does not change; rather, the variation relates to the percentage of ownership allocated to the investor and the entrepreneur after the investment.[120] Attributing a lower or higher valuation does not necessarily affect the potential of the firm;

114. An investor making a high-risk investment in an early stage company may require a 30x return on their investment at the time of exit. This means that if the projected future value of the business is $3 million at time of exit, then the investor would only invest $30,000 for 100% of the equity ownership and $15,000 for 50% of the equity ownership.

115. *See* Sophie Manigart et al, *Determinants of Required Return in Venture Capital Investments: A Five-Country Study*, 17 J. Bus. Venturing 291 (2002) (exploring the rate or return required by venture capitalists based upon multiple risk factors at various stages of venture development).

116. *See* Messica, *supra* note 101, at 43–44.

117. Shepherd & Zacharakis, *supra* note 73, at 142–43 ("Perceived fairness most often focuses on valuation and equity dilution to secure funding. Valuation is often highly contentious primarily because of a lack of information.").

118. *See* Messica, *supra* note 101, at 44 (noting the methods of firm valuation for start-up ventures derive from the uncertainty in the venture performance).

119. David H. Hsu, *What Do Entrepreneurs Pay for Venture Capital Affiliation?* 59 J. Fin. 1805, 1807 (2004) (noting that highly desirable venture capitalists generally receive a 10–14% discount on the valuation of equity).

120. *See* Gompers, & Lerner, *supra* note 104, at 91 (illustrating the calculation of ownership percentage based upon pre-money and post-money valuations).

rather it affects the level of cooperation between the parties, which in turn affects the firm's performance. For example, a lower valuation will reduce the potential gain for the entrepreneur from an exit event due to the entrepreneur's reduced equity ownership percentage. This scenario may reduce the entrepreneur's incentive to maximize venture performance, which works to the detriment of all parties as venture performance diminishes.

As discussed above, settling upon a valuation aptly demonstrates the potential outcomes of the trust-control interplay within this pseudo-competitive relationship. In the first scenario, the entrepreneur will allow the investor greater control in valuation by accepting a lower valuation or a higher required return by the investor, resulting in a relationship with low levels of trust and highest chances of entrepreneur opportunism.[121] For example, the entrepreneur may feel that she is being taken advantage of in the transaction. As such, an investor who pushes for a low valuation based upon the perceived level of risk in the investment risks creating mistrust and reducing the level of cooperation from the entrepreneur in the operations or strategic decision making.[122] In the second scenario, the entrepreneur will refuse to concede a given level of control to the investor by arguing for a lower valuation or rejecting the investor's required return on investment.[123] If the investor is unwilling to accept these terms, the situation may result in a failure of the funding deal. In the third scenario, the equity investor consciously forgoes the desire for greater control over the valuation or valuation method in order to build trust in the current and future rounds of financing.[124] In such a scenario, other term sheet provisions may serve to reduce the investor's perceived risk in a lower valuation while preserving the level of cooperation between the parties. For example, a valuation term sheet item that takes the risky nature of early stage valuation into account and minimizes the risk exposure through gradual investments and fair valuation methods will allow trust and a relational contract to develop over time.

The risk allocation effect of attributing a higher or lower valuation to a business venture necessitates a method for maximizing venture performance through valuation. To achieve this objective, each party must work to understand the subjective risk perceived by the other party when em-

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121. *See* Rosalined H. Woolthuis et al., *Trust, Contract and Relationship Development*, 26 Org. Studies 813, 814 (2005) ("The active form of opportunism entails 'interest seeking with guile'; lying, stealing and cheating to expropriate advantage from a partner. The absence of such active opportunism is called 'benevolence' or 'goodwill'. Thus, intentional trust has two dimensions: trust in dedication and trust in benevolence/ goodwill.") (internal citation omitted).

122. *See* Cable & Shane, *supra* note 75, at 142–76 (employing the prisoner's dilemma framework to demonstrate that the nature of the entrepreneur-investor relationship can create incentives that affect the level of cooperation in the relationship, which ultimately affects the decision making of the parties).

123. *See infra*, Section II.C, paragraph 4.

124. *Id.*

ploying any valuation method. Such understanding may heighten the cooperation between the parties and diminish the heightened control measures employed through the competitive negotiation process.

B. *Risk as it Relates to the Amount and Timing of Investment*

Risk preference affects both the amount of money that an investor is willing to invest and the amount that an entrepreneur seeks in equity investment.[125] Procedurally, each party understands that early equity investment in a start-up venture is very costly to the entrepreneur and very uncertain for the investor.[126] The uncertainty of financial success of the venture causes early investors to seek higher returns on the investment and, thus, lower valuations for the equity purchased.[127] As the venture performs and accumulates assets, outside financing generally becomes cheaper and more easily available.[128] In turn, the lower risk of business failure at later stages of growth diminishes the investor's required rate of return.[129] However, at early stages of a new venture, the entrepreneur faces the risk of over-diluting her ownership too early in the life of the business. A lower valuation at an early stage requires that the entrepreneur sell a greater share of equity to the investor to meet business capital needs.[130]

The parties allocate the above-stated risk by placing limits on the amount and timing of the equity investment.[131] For example, the parties

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125. De Clercq et al., *supra* note 8, at 99 ("[I]n early stage ventures, the actual equity received for a given level of investment is much more likely to be determined by prevailing norms than any actual calculation of realistically expected future cash flows. In essence, the [venture capitalist] needs to believe that the target rate of return has a reasonable chance of being reached within her required time to exit."); *see also* Amit et al., *supra* note 5 (noting that more successful firms generally defer involvement of outside capital).

126. De Clercq et al., *supra* note 8, at 99 ("With multiple investors involved and with great future uncertainty, the end result is that [venture capitalists] generally receive significant ownership stakes in their ventures, especially in those receiving money in early stages.").

127. Balasubramanian Elango et al., *How Venture Capital Firms Differ*, 10 J. Bus Venturing 157, 157 (1995) ("Earlier stage investors sought ventures with higher potential returns—a 42% hurdle rate of return for the earliest stage investor versus 33% for the late-stage investor."); *see generally* John H. Cochrane, *supra* note 51.

128. Cuny & Talmor, *supra* note 21, at 3 (citing Darwin V. Neher, *Staged Financing: An Agency Perspective*, 66 Rev. Econ. Studies 255, 255–74 (1999) ("[A]s human capital is gradually transformed to physical capital, the venture increases the value of its collateral, hence makes outside financing more affordable.").

129. De Clercq et al., *supra* note 8, at 100 ("[T]he entrepreneur will end up with a larger share because the required IRR for the [venture capitalist's] investment is typically lower in later rounds as the level of risk decreases (i.e., the valuation of the company goes up in subsequent rounds), thus shifting investment to a later round lowers dilution.").

130. D. Gordon Smith, *Team Production in Venture Capital Financing*, 24 J. Corp. L. 949, 968 (1999) [hereinafter Smith, *Team Production*] ("Another danger is that subsequent rounds of financing may substantially dilute the Entrepreneur's interest in the company.").

131. *See* Cuny & Talmor, *supra* note 21, at 6–10 (providing a mathematical model for allocating the amount and timing of funding through milestone financing).

may seek to invest a certain amount of capital in a given equity round or, in the alternative, agree to invest funds at various milestones or points in the business lifecycle.[132] With regard to the timing of investment, the use of single-event or milestone financing demonstrates the spectrum of risk allocation between the parties. Milestone financing involves investing at various stages of the business' development and helps the parties to build trust.[133] It allocates a higher level of performance risk to the entrepreneur because the venture must reach given milestones before receiving a certain level of funding from the investor.[134] Such a scenario may affect the entrepreneur's decision making and the goals she sets for the venture. In turn, later stage financing may reduce the risk to the investor by incentivizing the entrepreneur's efforts.[135]

Staging capital can serve as a method by which an investor controls the development of a start-up venture.[136] In fact, staged financing is often one of the strongest control techniques a venture capitalist exercises over early-stage start-ups.[137] It is common for investors to use future financing stages as leverage to exercise additional controls over the business.[138] Staged financing provides protection for investors from losses when the venture is not going well;[139] however, it can put the investor in a greater position of control by way of this potential holdup position.[140] Further, stage financing may allow the investor to acquire majority control of voting shares after multiple stages of financing.[141] When negotiating the timing of financing, the willingness of each party to trust or allow the other

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132. Smith, *Exit Structure*, *supra* note 46, at 323 ("Staged financing occurs when venture capitalists invest incrementally in their portfolio companies.").

133. *Id.* at 323–24.

134. *See* Smith, *Team Production*, *supra* note 130, at 966 ("Staged financing [is] the practice of investing only enough money to allow the Entrepreneur to progress to the next milestone in its business plan.").

135. Cuny & Talmor, *supra* note 21, at 3 ("[A] commitment to syndicate financing in later stages reduces the entrepreneur's under provision of effort.") (citation omitted).

136. *See* Sahlman, *supra* note 42, at 506 ("The most important mechanism for controlling the venture is staging the infusion of capital.").

137. Smith, *Exit Structure*, *supra* note 46, at 324 ("They are more important to the balance of control in the early lives of most venture-backed companies than the redemption rights and the registration rights discussed in Part II because other rights are typically not available to venture capitalists for a period of years after the initial investment.").

138. *Id.* at 323 ("If the venture capitalists want to wrest control from an entrepreneur, they may demand majority board control in exchange for additional financing.").

139. *Id.*

140. Neher, *supra* note 128, at 255–56; *see also* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298–302 (1978).

141. Smith, *Exit Structure*, *supra* note 46, at 324 (citing Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 288 (2003) ("Staged financing also typically involves the staged acquisition of control. More often than not, venture capitalists do not acquire a majority of the votes in the initial round of financing.")).

party control may cause either party to limit or expand the offering to a certain size. These considerations become particularly important when the investor tries to pressure the entrepreneur into dealing solely with the investor's firm in the present or a future equity funding transaction. In such exclusivity scenarios, trust may be compromised given the leverage the investor has gained.

Milestone financing also includes an element of trust because it may increase the risk of lower returns to the investor.[142] The amount of equity purchased in later financial rounds is generally more expensive or costly per share, so the investor receives less equity (a lower number of shares) for their investment.[143] Similarly, a single round of financing presents an increased risk of loss to the investor. A single round requires more funds from the investor at a more uncertain point in the business lifecycle.[144] As such, it allocates the risk of higher losses to the investor early in the relationship.

The preferable position for the investor with regard to the timing of financing depends upon her perception of risk of loss versus the perception of the risk of lower returns. As for the entrepreneur, a single round of financing increases risk by raising the cost of the investment (selling more equity at a lower equity valuation).[145] Milestone financing poses the risk that the investor will elect to not invest the needed capital at a future point if she perceives the risk to be too high.

The typical entrepreneur is overly confident in her venture's prospects and excessively averse to the risk of distributing too many shares at an early stage. She may, therefore, view milestone funding in a favorable light. Generally, the entrepreneur's objective is to receive the greatest value for the least equity, with the lowest milestone threshold.[146] This may contrast with an investor who has significant confidence that the business will meet its financial goals. In such a case, the investor would want to acquire a greater percentage of equity at a lower valuation, leading to a preference for single round financing and a lower level of trust between the parties.

142. *See generally* Smith, *Exit Structure*, *supra* note 46.

143. *See* Michael Woronoff & Jonathan Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 Fordham L. Rev. 129, 136 (2005) (explaining economic dilution resulting from a drop in the value of shares in later rounds); *see also* Gompers & Lerner, *supra* note 104, at 91 (providing for the calculation of ownership percentage under the venture capital method based upon the size of the investment divided by the post-money valuation of the business).

144. *See* Smith, *Exit Structure*, *supra* note 46, at 324 ("Staged investments typically occur over a relatively short time period, almost always less than one year apart and frequently at much shorter intervals.").

145. This assumes that the start-up venture rises in value over time, which is generally a requirement for follow-on financing to take place.

146. De Clercq et al., *supra* note 8, at 100 ("[E]ntrepreneurs are faced with 'conflicting' objectives when negotiating a deal structure with an investor i.e., to give up as little equity as possible, to get as much cash as possible and to set milestone hurdles as low as possible.").

While the investor may wish to minimize downside risk, the effect of signaling a lack of confidence in the business venture may diminish the entrepreneur's motivation or incentivize self-serving behavior. Again, in an early state of coopetition, it is important to minimize control provisions that have the effect of prejudicing the overall performance of the venture. For example, if the entrepreneur perceives investor hold-up as a substantial risk, she may abandon the funding transaction or accept the investor control provision. Abandoning the transaction generally works to the detriment of both parties. Proceeding with the transaction, however, may lead to low levels of trust and higher likelihood of entrepreneur opportunism in decision making. In any event, the pseudo-competitive state dictates the need to cede a level of control to the entrepreneur that fits within the investor's risk propensity and is consistent with the entrepreneur's perception of risk in the timing and amount of investment. The strength of either party's awareness of or preference for the risks associated with timing and amount will drive the parties' objectives (control versus trust) during negotiation.

C. *Security Features*

The type of security instrument chosen for an investment transaction represents a form of structural control achieved through allocation of ownership rights attributable to a type or class of security.[147] Start-ups seeking funding from equity investors are generally organized as corporations.[148] The corporate form allows for ease and certainty in issuance of alternative classes of equity instruments to provide to investors in exchange for their investment funds.[149] The following section describes the various types of equity instruments used in venture financing and their primary characteristics. The attributes of each type of equity instrument serve as control provisions that allow for a unique risk allocation between the investor and entrepreneur.

Common stock is the basic type of equity that exists for every corporate entity.[150] A share of stock generally entitles the owner to one vote for shareholder matters under state law or as outlined under the governing

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147. *See* Sheridan Titman, *The Effect of Capital Structure on a Firm's Liquidation Decision*, 13 J. Fin. Econ. 137, 137–51 (1984) (demonstrating how the capital structure control liquidation decisions within the firm).

148. *See* Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 Tax L. Rev. 137, 137 (2003) ("A typical start-up is organized as a corporation under state law, which means that it is treated as a separate entity from its owners for tax purposes.").

149. Note that C-Corporation status allows for various classes of common and preferred stock. S-Corporation status limits the corporation to one form of stock, with limited exception for a class of non-voting common stock.

150. Alex Wilmerding, Term Sheets & Valuations: A Line-by-Line Look at the Intricacies of Term Sheets & Valuations 36 (2003).

documents.[151] Founders generally receive common stock at the formation of the corporation,[152] while new additions to the corporate team may receive common stock or options to purchase common stock as an employment incentive.[153] Common shares that are used as incentive compensation will generally vest over a period of time.[154] In the case that an employee is fired or leaves the business, the employee may not yet have vested in all of her stock award. This reduces risk to the business venture by protecting against situations where it is forced to repurchase a large number of outstanding shares. For reasons discussed below, common stock is rarely used in equity funding transactions with outside investors.

Venture capital investors will generally require a form of preferred stock for their investment.[155] Preferred stock, as the name denotes, bestows special rights upon the holder beyond those of common stock.[156] Notably, preferred stock provides the shareholder with priority over resources as stipulated by this security.[157] For example, if the investor accepts common stock for her investment, she risks suffering a loss while the entrepreneur benefits from an early exit event.[158] As with any financing relationship, the extent of priority afforded the preferred shareholder in a start-up venture is the subject of negotiation between the entrepreneur and investor. Many of the attributes of preferred stock are control terms that mitigate investor risk in a low trust context and allow for negotiation of numerous control mechanisms within the investment relationship.

The attributes common in preferred shares of a start-up venture, but not necessarily present in the preferred shares of a public company, are discussed in the subsections that follow.

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151. Henry Hansmann, The Ownership of Enterprise 15 (Harvard Univ. Press 2000).

152. Wilmerding, supra note 150.

153. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 NYU L. Rev. 967, 1010 (2006).

154. *See* Gompers, & Lerner, *supra* note 104, at 139 (providing an overview of vesting of equity awards)*; see*, *e.g.*, Tom Taulli, How to Create the Next Facebook 20–21 (2012) (demonstrating a situation where equity incentives vest on a schedule).

155. Sridhar Arcot, *Participating Convertible Preferred Stock in Venture Capital Exits*, 29 J. Bus. Venturing 72, 73 (2013) ("PCP stock is routinely used in venture capital contracts. [Kaplan & Stromberg, *supra* note 141] report that nearly 80% of all venture contracts use convertible preferred stock and that in nearly half of those cases the stock is participating.").

156. *See generally id.*

157. *See id*. at 72–75 (providing an overview of the shareholder rights provided in preferred convertible shares).

158. For example, if the investor invests $1,000,000 in exchange for 50% of the business and the entrepreneur simply invests time and effort, then the entrepreneur may have the incentive to seek an early exit that benefits her but not the investor. The entrepreneur could agree to sell the business for any value below $2,000,000. In such a case, the investor would either break even or lose money on the deal, while the entrepreneur would receive nearly all of the benefit.

1. Conversion Rights

The most commonly used type of equity in venture financing is the convertible preferred share.[159] Conversion rights refer to the ability of the preferred shareholder to convert her shares into common stock if holding common shares would be more advantageous to the shareholder than owning the preferred shares.[160] For example, at the time of exit or sale, the preferred shares may yield a return that is lower than the return from the equivalent amount of common stock.[161] In such a situation, the investor will have the incentive to convert her preferred shares into common stock to take advantage of the higher return.[162] As such, conversion provisions mitigate investor risk of loss from holding the preferred shares, while preserving the advantages of holding the preferred shares.

Conversion rights may also serve a risk mitigation function for the entrepreneur. Conversion of preferred shares is generally at the option of the preferred shareholder, but also automatic at some point or upon some event.[163] As previously stated, optional conversion will generally occur when the value of the common stock exceeds the benefits or return associated with preferred shares. An automatic-conversion clause, on the other hand, calls for preferred stock to be automatically converted to common stock upon some event, such as making the filings necessary for an initial public offering.[164] Thresholds for automatic conversion are fixed control points and are important points of negotiation. An entrepreneur generally wants lower thresholds for conversion (such as a given revenue point) in order to provide for flexibility when seeking an exit event, while investors may claim additional control by seeking higher thresholds.

Negotiation of a specific event or threshold for conversion represents an effort to mitigate one party's perceived risk. It recognizes that any such event or threshold represents the opportunity for one party to act opportunistically at the expense of the venture or the other party. In an absence of trust in the other party's actions, one party will seek to use conversion rights to control the actions of the other party. While any level of control may reduce the amount of cooperation in the relationship, a certain level of control that does not enter into the other party's view as a perceived risk may facilitate a cooperative relationship.

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159. *See* Arcot, *supra* note 155; *see also* Paul A. Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments* 3, 13 (1999) (unpublished manuscript) (on file with author).

160. Wilmerding, *supra* note 150, at 49.

161. *See* Arcot, *supra* note 155, at 74.

162. *See id.*

163. Smith, *Exit Structure*, *supra* note 46, at 354 ("Generally speaking, venture capital investments contain two types of conversion provisions: (1) optional conversion which allows the venture capitalist to convert at will; and (2) automatic conversion which requires the venture capitalist to convert upon the occurrence of specified events, most importantly an [initial public offering].").

164. *Id.*

2. Liquidation Preferences

A liquidation preference grants the investor priority in recuperating her investment if the business is sold or undergoes some other exit event.[165] Liquidation preferences are closely connected with conversion rights. Generally, an investor will not convert preferred shares to common shares when the value of the common shares is less than the liquidation preference amount.[166] Conversely, if the value of the preferred shares when converted to common stock exceeds the liquidation preference, then the investor has an incentive to convert the shares.[167] The liquidation preference protects the investor against early exits that fail to capture the anticipated value of the business venture by allowing the investor to be compensated (or receive a return on capital) before the entrepreneur receives any funds from the exit event.[168] The liquidation preference often goes beyond simply assuring a return of the investor's funds—it may return some multiple of the initial investment.[169] This means the investor will get some multiple of their liquidation preference if the business goes through an exit event.

A liquidation preference is a security measure that mitigates the investor's risk of financial loss relative to other shareholders, including the entrepreneur. While generally understood to mitigate risk for the investor and shift that risk onto the entrepreneur, a liquidation preference protects against opportunism by the entrepreneur in seeking an exit event that does not benefit the investor. Contrary to the cooperative state desired in a relationship contract, the entrepreneur might interpret this provision as demonstrating a lack of trust. While the investor perceives a risk of loss or opportunism by the entrepreneur, the liquidation preference may increase the incentive for other forms of opportunism and lack of cooperation. Depending on how the entrepreneur perceives the risk-shifting effect of the liquidation preference, the investor's perception of risk may thwart the common objective—creating value in the firm.

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165. *See* Wilmerding, supra note 150, at 44.

166. Smith, *Exit Structure*, *supra* note 46, at 355 ("Timothy Harris [Timothy J. Harris, *Modeling the Conversion Decisions of Preferred Stock*, 58 Bus. Law. 587 (2003)], has modeled the 'conversion decision' facing venture capitalists in the context of an acquisition, and he shows why venture capitalists will not convert their preferred shares into common shares when the acquisition price is less than or equal to the total value of the liquidation preferences.").

167. *Id.* ("The 'conversion point' for venture capitalists comes when the acquisition price is large enough that venture capitalists benefit from conversion, that is, when that value that venture capitalists would receive from holding common stock exceeds the value of their liquidation preference and any participation rights.").

168. *Id.* at 348 ("The liquidation preference ensures a modicum of protection against misappropriation because it must be paid prior to any payments being made to the entrepreneur, and the participation provision deters the controlling entrepreneur from upside exits, that is, exits that may seem favorable to the entrepreneur but not the venture capitalist.").

169. Gompers, & Lerner, *supra* note 104, at 129 (explaining the use of liquidation preferences as a means of compensating the venture investor).

3. Participation Rights

Participation rights give shareholders (including the entrepreneur) the right to participate in receiving any distributions from the business.[170] The participating shareholder receives a percentage of the funds distributed that is equal to her percentage of equity ownership.[171] As stated above, participation rights generally arise in the context of a liquidation preference. If the investor reserves a liquidation preference, she may also demand the right to participate in any distributions above the liquidation preference.[172] The terms of the liquidation preference may allow the entrepreneur to "catch up" before the investor receives any amount above the liquidation preference.[173] While participation rights are often combined with a liquidation preference, an unlimited participation right is generally seen as overly generous to the investor and participation rights are therefore frequently capped.[174]

Taken together, liquidation preferences, conversion rights, and participation rights are all control mechanisms used to allocate risk in the pseudo-competitive relationship between investor and entrepreneur. The presence and characteristics of each provision mitigates investor risk and shifts that risk to the entrepreneur. Perhaps most importantly, all of these provisions signal a reduced role of trust in the entrepreneur-investor relationship that thwarts the relationship characteristics desired in the agreement and may deter the entrepreneur who works in an underperforming business. In negotiations, the investor must balance the perceived risks addressed by the preferred rights against the entrepreneur's perception of fairness and the potentially negative affect of these provisions on firm performance. An entrepreneur should be willing to cede preferred rights to the investor based upon the extent of the investor's perceived risk. Failure to do so could result in diminished cooperation and lost venture value.

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170. Arcot, *supra* note 155, at 73 (" Participation rights entitle the [venture capitalist], in the event of sale or liquidation, to a liquidation preference plus a pro rata share of what remains to be paid to common shareholders. Thus, upon sale or liquidation, participating preferred shareholders have a debt-like claim equal to their liquidation preference plus a common shareholder's claim. In contrast, holders of nonparticipating convertible preferred shares either receive the liquidation preference payable on the preferred stock or they convert their shares to common stock and share pro rata with common shareholders.").

171. *See id.*; Harris, *supra* note 166, at 590 (explaining that participating preferred stock is often subject to a cap on compensation after receipt of the liquidation preference).

172. *See* Gomper, & Lerner, *supra* note 104, at 129, 131.

173. *See id.* at 129.

174. Smith, *Exit Structure*, *supra* note 46, at 347 ("In success scenarios, the combination of a liquidation preference plus an uncapped participation right is sometimes viewed by entrepreneurs as excessively generous to the venture capitalists. As a result, many venture capital deals cap the participation rights."); *see also* Gompers, & Lerner, *supra* note 104, at 128–30. If a liquidation preference exists and participation right is not capped, then combining participation rights with an optional conversion provision is largely useless. *Id.* An investor will not have a financial incentive to convert their shares into common shares. *Id.* The participation rights, however, are often capped. *Id.* This reality leads to prevalence of preferred convertible participating shares in equity funding transactions. *Id.*

D. *Other Common Term Sheet Provisions*

The following Section discusses common provisions found in term sheets that address and seek to allocate specific risks perceived by the investor and the entrepreneur. The extent of the protection afforded by each provision varies based on the level of protection required by a party and the trust afforded the other party.

1. Redemption Rights

Redemption occurs when a business repurchases shares from the business's equity holders.[175] Redemption rights are generally either optional or mandatory.[176] Optional redemption facilitates the venture capitalist's desire to exit a venture when the value created from any additional capital is approximately equal to the amount of new capital invested.[177] It is a foreseeable risk, however, that the firm will not grow and develop sufficiently to return the investor's capital (along with any interest or preferred returns) during the projected investment period. A demand redemption right is a strong control provision that minimizes the investor's risk of becoming stuck in a failing business.[178] A demand redemption right also allows the investor to control the entrepreneur's ability to seek an early exit from the venture,[179] which could result in a failure of the business to meet the investor's expectations for returns. At the same time, these rights augment the risk to the entrepreneur that the investor will effectively bankrupt the business by demanding a return of capital through a repurchase of her shares.

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175. Smith, *Exit Structure*, *supra* note 46, at 348 ("Redemption is a term that may cover many types of provisions. At its most general, redemption refers to any repurchase of shares by the company for an amount specified in the contract.").

176. *Id.* ("Venture capital transactions may have up to three different redemption provisions: (1) mandatory redemption, (2) optional investor redemption (put), and (3) optional company redemption (call).").

177. *Id*. at 345 ("Venture capitalists and entrepreneurs may have incentives to pursue different exit strategies. Douglas Cumming and Jeffrey MacIntosh sensibly suggest that venture capitalists will exit from an investment when the projected marginal value added by the venture capitalist's efforts equals the projected cost of those efforts.").

178. *Id.* at 348–49 (citing Lee F. Benton et al., *Hi-Tech Corporation: Amended and Restated Certificate of Incorporation*, *in* MICHAEL J. HALLORAN ET AL., 1 VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATION 8-1, 8-18 to 8-27 (Michael J. Halloran, et al. eds. 3d ed. 1997 & Supp. 2004)) ("Just interpreting the facial terms, the purpose of these provisions would appear to be twofold: to provide the venture capitalist with the means to extract the original investment from a company that seems unlikely to succeed; and to provide the venture capitalist with leverage over the entrepreneur based on the credible threat of withdrawal.").

179. *Id.* at 340 ("[V]enture capitalists and entrepreneurs usually structure their relationships in a manner that affords entrepreneurs some freedom from the threat of exit by venture capitalists at the beginning of the relationship and transfers greater control over exit decisions to venture capitalists as time passes. This is accomplished through several types of contractual provisions: (1) negative covenants (also known as "protective provisions"); (2) redemption (put) rights; (3) demand registration rights; and (4) conversion rights.").

Mandatory redemption, in contrast to demand redemption, normally occurs at a stated time, upon a specific occurrence, or staggered over a period of time.[180] If the business has not reached a point where it can sell or otherwise liquidate investor interest, the investor has the right to force the business to redeem some or all of the investor's shares, assuming the business has sufficient assets.[181] While mandatory redemption imputes a level of decision making by the investor at a given point in time, it lacks the extensive control afforded by the demand right. While the mandatory redemption provision is a risk allocation provision in favor of the investor, it reduces the level of control of the investor in determining when redemption occurs.

These control mechanisms demonstrate a distinct disparity in the intentions of the entrepreneur and the investor. While the entrepreneur seeks to continue growing the business, redemptions rights stand to thwart that growth in the event the investor either chooses to exit or the business fails to achieve certain growth goals that call for mandatory redemption. Redemption rights may also create a risk to the entrepreneur's ability to attract future investors because any future invested funds could be used to redeem the earlier investor rather than to grow the business.[182] While redemption rights serve to protect the investor against the perceived risks of business failure or a premature exit event, the entrepreneur perceives the investor's redemption right as a risk shifting mechanism demonstrating the investor's lack of trust in the entrepreneur's intentions or in the business venture's performance. Consistent with other control and risk allocation provisions, these provisions can defeat the intention of developing a relational contract by affecting the entrepreneur's decision making and decreasing the level of cooperation between the parties.

2. Registration Rights

Registration rights allow an investor to force the business to file a registration statement with the Securities and Exchange Commission (SEC) and state regulators.[183] They are generally categorized as piggyback or demand registration rights.[184] Piggyback rights allow an investor to par-

180. *Id.* at 348 ("Mandatory redemption requires the company to begin repurchasing shares at a specified date, usually subject to waiver by the venture capitalists. Such redemptions could be staggered over a period of months or years to lessen the impact on the company.").

181. *Id*. at 348–49.

182. *Id.* at 349 ("Indeed, such provisions may dissuade future investors from providing additional capital for the simple reason that the capital may be used to finance the redemption rather than the operations of the firm.").

183. Wilmerding, *supra* note 150, at 64–65.

184. Smith, *Exit Structure*, *supra* note 46, at 344 (citing Phillippe Aghion et al., *Exit Options in Corporate Finance: Liquidity Versus Incentives*, 8 Rev. Fin. 327, 348 (2004)) ("If [venture capital] investors hold a minority stake their exit will depend on decisions reached by majority shareholders. Therefore [venture capital] investors often require a registration rights agreement giving them the right either to have their shares included in an [initial public

ticipate in any registration of the business' securities.[185] That is, if another class of security holder registers a class security, then the investor with piggy back registration rights can also participate in that registration.[186] Demand rights, on the other hand, provide the investor with the ability to force the business to register a class of shares with the SEC.[187] Demand rights are often contingent on the occurrence or non-occurrence of certain events or conditions.[188]

Allowing investors to control the decision to make a public offering of the business' shares protects the investor when the entrepreneur has majority control and complete decision making authority over the business.[189] The shareholder can either sell her shares in any public offering or force a public offering as a method of exiting the venture.[190] While piggyback registration rights mitigate the investor's perceived risk, demand rights shift control to the investor and risk to the entrepreneur. Specifically, an investor may demand registration to pursue an exit that does not benefit the entrepreneur or the business. This particular situation, known as grandstanding, occurs when the investor seeks an exit to promote personal interests rather than those of the business.[191] In practice, parties negotiate to limit the ability of the investor to unilaterally initiate a public offering;[192] as such, registration rights are more of a tool that offers the investor leverage or control in the relationship.[193]

The effect of registration rights as term sheet provisions is to recognize a lack of trust in the entrepreneur's decision to pursue an exit event and

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offering] (so-called "piggyback rights") or to request that an [initial public offering] or private placement of shares take place (so-called "demand rights").").

185. Valerie Ford Jacob, et al., *Key Considerations in Drafting a Registration Rights Agreement from the Company's Perspective*, 41 REV. SEC. & COMMODITIES REG. 113, 118 (2008).

186. *Id*. at 118–19.

187. *Id*. at 116.

188. *Id*. at 116–7.

189. *See* WILMERDING, *supra* note 150, at 65–68 (providing examples of registration provision demonstrating alternating levels of investor control).

190. Jacob et al., *supra* note 185, at 118.

191. Smith, *Exit Structure*, *supra* note 46, at 351 ("Without private benefits from continuation, the most dramatic risk to the entrepreneur is that the venture capitalist will attempt to extract wealth under threat of pursuing an exit strategy that is unfavorable to the entrepreneur. Less dramatically, the venture capitalist might engage in 'grandstanding'—taking the company public too early, which reduces the financial value of the transaction to all parties but results in private benefits to the venture capitalist, such as the reputational boost that accompanies the funding of a successful company.") (internal citation omitted).

192. *Id.* at 353 ("The practice of postponing the effective date of registration rights with each new investment implies that demand rights are not designed to provide venture capitalists with the right of initiation.").

193. *Id.* at 353–54, ("Gunderson et al., assert that demand registration rights are 'rarely used,' but suggest that they 'often provide Investors with leverage in dealing with management with respect to the nature and timing of Company-initiated registrations.'") (internal citations omitted).

allocate additional control to the investor. The inclusion of either piggyback or demand right provisions is a recognition of the investor's perceived risk and a demonstration of a lack of trust in the entrepreneur. The choice of the type of registration right will vary the level of control demanded, but the inclusion of a registration right itself acknowledges perceived risk and demonstrates a lack of trust. While the provisions may be necessary to reach an agreement, these provisions run counter to the development of a relational contract. The parties should be aware of this effect and negotiate these provisions in a manner that has the least potential to hinder cooperation between the investor and entrepreneur, which can sacrifice firm value.

3. Terms Related to Subsequent Rounds of Equity Offerings

Investors and entrepreneurs may incorporate controls concerning the right or obligation to invest in any new offerings of the business' equity and concerning any barriers to the sale of equity to outside parties. A common provision is the pay-to-play provision, which incentivizes investors to take part in future rounds of financing of the start-up.[194] This provision requires an investor to invest in future equity rounds at an amount equivalent to her percentage of equity ownership in the business. This helps to avoid dilution and the potential loss of preferential rights.[195] The pay-to-play provision also protects the entrepreneur from the risk that the investor will hinder future rounds of financing by refusing to roll her equity position into the new offering.[196] This provision may demonstrate the entrepreneur's perceived risk that the investor will fail to follow through on assurances of participation in additional financing rounds.

Depending on how the provision is structured, the investor may see pay-to-play provisions as a favorable control mechanism that reserves her right to participate in future offerings. As such, the provision could represent the perceived risk that the entrepreneur will act opportunistically in seeking to exclude the investor in future rounds of financing. In either event, allocating control over participation in future funding rounds demonstrates an absence of trust in the other party's intentions. As with other such provisions, these provisions can run counter to relationship contracting and diminish the cooperation between the parties.

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194. John R. LeClaire et al., *WatchMark Ruling Clarifies Pay-To-Play*, 45 VENTURE CAP. J. 64, 64 (2005).

195. *Id.* If the investor fails or is unable to provide the necessary amount of funds, she will lose some preferred rights associated with her equity. *Id.* For example, the investor may lose a degree of anti-dilution protection by failing to participate. *Id.* In a down round, where equity is sold at a cheaper rate than in prior rounds, this is a very important provision because a failure to participate will cause dilution and a loss of overall value.

196. *Id.* at 65. It is common for the investor to lose preferred rights automatically or at the insistence of the other business owners in order to facilitate the new offering. For example, the investor may be forced into converting the preferred stock into a lesser form of preferred stock or into common stock.

4. Preemption, Co-Sale & Drag-Along Rights

Preemption rights are control mechanisms that generally grant one party the right of first refusal to purchase shares being offered for sale by an existing shareholder.[197] For example, a business may hold the first right to purchase any shares sold by any shareholder, who can only sell the shares to an outside party if the business first refuses to purchase them.[198] Through the decisions of the business' owners or directors, the business retains the option of refusing to purchase the shares.[199] If the business elects to purchase the shares, however, the shareholder is entitled to the price per share agreed upon by a disinterested third party.[200] Preemption rights are often accompanied by ancillary shareholder agreements that further limit the ability of investors to sell or otherwise transfer ownership in the business.[201] These provisions protect the existing business owners from a perceived risk of opportunistic behavior by other shareholders. While these provisions stand to affect both the investor and the entrepreneur, they more commonly protect the entrepreneur from an investor who wishes to exit the venture through the sale of her shares to unknown and potentially undesirable third parties.

Co-sale rights are control provisions that protect the investor's interest by preventing founding entrepreneurs from selling their equity interests and leaving equity investors still holding their shares.[202] While these provisions mitigate rather than shift risk among the parties, they also demonstrate a general lack of trust in the intention of the entrepreneur with regard to the venture. Drag-along rights, on the other hand, are control provisions that can protect against minority shareholders holding up a deal for the sale of the business.[203] These provisions have a risk shifting effect and may protect or detriment either the investor or the entrepreneur, de-

197. Armin Schwienbacher, *Venture Capital Exits*, *in* VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 387, 391 (2010) (Douglas Cumming ed., 2010) ("Preemptive Rights: the right of a shareholder to retain some predetermined percentage of ownership in the firm when new shares are issued."); WILMERDING, *supra* note 150, at 69; *see also* David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 4–5 (1999). *See generally* Sushil Bikhchandani, Steven A. Lippman, & Reade Ryan, *On the Right-of-First-Refusal*, 5 ADVANCES THEORETICAL ECON. 1 (2005) (providing an economic analysis of the generic right of first refusal in contracts).

198. *See* Walker, *supra* note 197, at 8–9.

199. *See id*. at 9–10.

200. *Id.*

201. *See id.* at 8–9.

202. Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, 6 N.C.J.L. & TECH. 223, 235 (2004) (explaining that co-sale rights allow a shareholder to sell her shares on an equal field with other shareholders because if any holder of an equity interest sells a determined percentage of their shares in the business, the other investors have the option of selling their shares as a portion of the deal).

203. Schwienbacher, *supra* note 197, at 391 ("Drag-along right is a call option given in a trade sale to the strategic buyer on a partner's shares (e.g., entrepreneur's) when another partner (e.g., the venture capitalist) sells hers.").

pending upon the equity structure. While a majority-shareholder entrepreneur is protected against investor hold up, a minority-shareholder entrepreneur risks losing control of her business when majority-shareholder investors pursue an exit event. The status of the entrepreneur as majority shareholder is subject to change as the ownership interest of the entrepreneur is diluted with every subsequent round of investment.

The generally neutral effect of co-sale and preemption rights on the allocation of risk and the potential risk-shifting effect of drag-along rights make these provisions demonstrative of the overall level of trust and cooperation between the parties. They are representative of the level of protection required by either party based upon a perceived risk in the other party's conduct. These provisions can be powerful tools in an attempt to achieve a relational contract that promotes trust and cooperation. Unfortunately for the parties, these provisions also have the potential to adversely affect the level of cooperation between the parties.

5. Anti-dilution Measures

Dilution is the reduction in the percentage ownership interest of an existing investor when a business issues new equity.[204] Anti-dilution provisions protect early investors from the risk of dilution by later rounds or stages of investment.[205] Anti-dilution provisions are generally divided into full-ratchet anti-dilution provisions and weighted-average anti-dilution provisions.[206] While full-ratchet anti-dilution provisions are the strongest control provisions and provide the greatest protection to the investor, weighted-average anti-dilution provisions also provide considerable protection for the investor.[207] The extent of protection afforded an investor under a weighted-average anti-dilution provision depends heavily upon the formula used to calculate outstanding shares, which are referred to as narrow-based and broad-based calculations.[208] Among these calculations, the narrow-based formula for determining anti-dilution protection offers greater protection to investor through a lower conversion price.[209]

As previously discussed, protecting a present shareholder from dilution in future financing rounds is a strong investor preference. Entrepreneurs, who possess common stock, cannot reserve anti-dilution protection for themselves because common stock is not convertible to another form of

204. *See* Wilmerding, *supra* note 150, at 53.

205. Vladimir Atanasov, *Conflicts of Interest and Litigation in the Venture Capital* Industry, *in* Venture Capital Investment Strategies, Structures, and Policies 365, 371 (2010) ("The anti-dilution provision serve the role of standard preemptive rights in protecting the [venture capitalists'] ownership stock from being diluted by the common stock holders in future rounds of financing.").

206. *See* Gompers, & Lerner, *supra* note 104, at 145–48.

207. *See* Wilmerding, *supra* note 150, at 51–56 (providing examples of anti-dilution clauses reflecting each of the discussed approaches).

208. Woronoff & Rosen, *supra* note 143, at 147–49 (2005)

209. *Id.*

equity.[210] As such, investors with anti-dilution protection enjoy a benefit above that of entrepreneurs and non-preferred investors. While this control mechanism reduces the risk to the investor, it generally exposes the entrepreneur to a greater risk of dilution from later rounds of equity financing.[211] A point of conflict arises where the special treatment of investors with regard to dilution protects the investor at the expense of the entrepreneur. This scenario has the potential to introduce a point of conflict between the parties during future rounds of financing. For example, it may affect the willingness of the entrepreneur to seek future rounds of equity funding, even when additional equity funding is in the best interest of the venture. Any such point of conflict serves as a hindrance to achieving a relational contract where cooperation drives increased firm performance.

6. Special Provisions for Investor Control

Investors often negotiate into the term sheet several specific control provisions reserving the ability to vote for the election of directors or for the approval of certain business actions. These terms, generally referred to as voting rights, grant the right to preferred shareholders to participate in voting alongside common shareholders.[212] This is an important power because the ability to vote on corporate affairs is often a primary characteristic separating preferred and common shareholders. Another common investor control provision, known as protective rights, requires voting approval by a class of preferred shareholder for certain events, such as pursuing an exit event.[213] The parties may select many types of events that require preferred shareholder approval.[214] These approval requirements are perhaps the most direct control mechanisms available to the investors.

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210. See Marcel Kahan, *Anti-Dilution Provisions in Convertible Securities,* 2 Stan. J.L. Bus. & Fin. 147 (1995) (providing general information on the how anti-dilution as applied to convertible securities).

211. Robert E. Hall & Susan E. Woodward, *The Incentives to Start New Companies: Evidence from Venture Capital* 11 (Nat'l Bureau of Econ. Research Working Paper No. 13056, 2007), *available at* http://www.nber.org/papers/w13056 ("Almost all contracts between venture funds and entrepreneurs shift value toward venture in the case of a down round, through anti-dilution provisions.").

212. Wilmerding, *supra* note 150, at 58.

213. Smith, *Exit Structure*, *supra* note 46, at 346 ("Provisions requiring the approval of business combinations (for example, mergers or consolidations) have obvious application. Because [initial public offerings] almost inevitably require an amendment of the corporation's charter, the right to prevent such amendments provides effective control over the timing of such an offering.").

214. Examples of actions for which parties may require shareholder approval include: merger, recapitalization, sale of major assets, changes in rights of preferred shareholders, increasing/decreasing authorized common or preferred shares, creation of new classes of shares with senior preferences or privileges to the preferred shareholders, decisions regarding redemption of stock, changes bylaws or certificate of incorporation, increases or decreases the size of the board of directors, decisions on the payment of dividends, issuance of debt of a predetermined amount or setting a debt threshold.

They demonstrate a distinct lack of trust in the decision making of the entrepreneur or other business managers. To protect against total control by the investors, the parties will often designate a minimum threshold of preferred shares outstanding before such provisions become effective.

Investors may also require a control provision identifying specific board seats for themselves or their representative.[215] The investor may require that the new class of shares holds the authority to elect a predetermined number of directors to the board of directors.[216] Through staged or subsequent rounds of financing, the investor will require more seats on the board and greater control over the business.[217] In other words, investors may acquire additional board seats either through negotiation or through acquisition during future financing.[218]

Lastly, investors may attempt to exert a level of control by requiring rights to monitor certain functions or business activities, typically referred to as information rights.[219] Prior research has investigated venture capitalist's responses to the timeliness with which entrepreneurs shared information and the level of influence and control the venture capitalist exerted over the strategic direction of the venture.[220] Results indicate that investors seek a balance between the ability to control over the venture and the ability to exit the venture, which reduces risk by providing greater liquidity.[221] Provisions that enhance investors' ability to exit the venture, therefore, may allow for less strenuous monitoring rights.[222] Conversely,

215. Wilmerding, *supra* note 150, at 61.

216. Smith, *Exit Structure*, *supra* note 46, at 326 ("Almost all of the board composition provisions follow the same three-stage structure: (1) A specified number of board seats are allocated to the holders of each series (or multiple series voting together) of preferred stock; (2) a specified number of board seats are allocated to the holders of common stock; and (3) any remaining board seats are filled by the holders of preferred stock and the holders of common stock voting together as a single class.").

217. *Id.* at 326–27 ("Because venture capitalists typically gain additional board seats with each round of investment, over time the board composition provisions of venture-backed companies tend to move from 'entrepreneur control' or 'contingent control' to 'investor control.' ").

218. *Id.* at 317 (citing William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 Mich. L. Rev. 891, 921 (2002)) ("Control is thus contingent only in the sense that it shifts from common stockholders to preferred stockholders over successive stages of financing, and this can occur either because the venture capitalists bargain for additional seats on the board or because the venture capitalists acquire a majority voting stake in the company.").

219. *See* Wilmerding, *supra* note 150, at 64.

220. Sapienza & Korsgaard, *supra* note 71, at 545, 549–51.

221. *See* Ernst Maug, *Large Shareholders as Monitors: Is There a Trade-Off Between Liquidity and Control?*, 53 J. Fin. 65 (1998). *See generally* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991).

222. Smith, *Exit Structure*, *supra* note 46, at 337 ("Investors who have easy exit options will have correspondingly fewer incentives to invest in monitoring that is designed to improve ongoing performance.").

investors may be willing to forgo enhanced exit options with greater monitoring rights.[223]

The provisions described above are a summary of major ancillary provisions that may or may not be present in a term sheet or subsequent investment contract. These provisions are notable because their inclusion in the term sheet demonstrates early recognition by investors of perceived risks related to decision making within the business. This fact can set the tone or serve as a bellwether for the nature of the relationship between the parties. A relational contract between the parties may exclude these provisions, whereas a discrete contractual relationship may contain any number of these provisions. In any event, the research demonstrates the interplay between perceived risk and the allocation of control rights to a single party. Consistent with the above discussion, these control rights reduce the trust afforded a party and, in turn, affect cooperation between the parties.

7. Special Employee Provisions

The parties often negotiate numerous employee-related provisions into the term sheet. These provisions serve as control mechanisms to either incentivize current management or allocate control over management to the investor. As discussed throughout, the control provisions employed by the investor seek to wrest away control of aspects of the business from individuals managing the business. Regarding the internal management of the venture, investors may want to control specific aspects of the hiring and incentivizing of managers.[224] For example, the retention of current management, namely the entrepreneur and her team, may be an express condition to the funding deal.

An obvious conflict arises when the investor does not want to retain the entrepreneur as the business leader.[225] A controlling entrepreneur is likely to step down upon investor request when the business is financially constrained.[226] Research indicates that the more developed the business, the greater the likelihood that the entrepreneur will step aside.[227] This coincides with the tendency of a controlling investor, generally a later

223. *Id.* at 337–38 ("The corollary holds that investors may be willing to foreclose exit options where monitoring is sufficiently valuable to the firm."); *Id.* at 338 (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)) ("The decision to constrain exit options may be made by the firm or the investors. In either event, the costs of reducing liquidity should be borne by the firm.").

224. *See* WILMERDING, *supra* note 150, at 76–78.

225. Hellmann, *supra* note 7, at 57 ("Probably the most contentious issue is the composition of top management, especially whether a founder should (at some point) resign from his or her position as the CEO.").

226. *Id.* at 70 ("Wealth-constrained entrepreneurs are more likely to relinquish control, even if it hurts the entrepreneurs interest more than it helps the venture.").

227. *Id.* at 58 ("The probability of the entrepreneur being replaced rises with the age of the business.").

round investor, to prefer a professional manager to manage the on-going affairs of the business.[228] Recall that the entrepreneur managing a business receives unique benefits from those of the investor, who focuses on a return on investment.[229] As discussed above, this can thwart cooperation or create dissent between the parties.

As a corollary, the investor may see the entrepreneur leaving the venture as a significant risk for future success. In light of this perceived risk, following a round of equity investment, entrepreneurs generally receive additional ownership interest in the business that vests over a predetermined period of time.[230] These provisions add certainty that the entrepreneur will continue to manage the business for an extended period. If the entrepreneur leaves early, any non-vested stock is lost and the vested stock is subject to buyback at a predetermined price.[231]

Within the capitalization structure, the parties routinely designate a specific percentage of the business' shares for use as incentives or as compensation to management.[232] These equity reserves use compensation to incentivize employees to perform at their best.[233] As with founders, employees incentivized with equity ownership in the business will generally have their equity interest vest over a specified period of time.[234] Allowing stock to vest over a specified period aligns company and employee interests and provides employees with an incentive to grow the value of the business. This provision protects investors from losing money and the employee from unfairly profiting when the business is sold very early in its development.[235] If employees fail to perform and are fired prior to all of the stock vesting, then the firm will have to repurchase less equity. As an

228. *Id.* at 70 ("[W]hen venture capitalists have control, they provide greater effort in finding professional managers who increase the value of the company.").

229. Smith, *Exit Structure*, *supra* note 46, at 345 (citing Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture-Capital-Financed Firms*, 2002 Wis. L. Rev. 45, 132).

230. *See* Hellmann, *supra* note 7, at 58.

231. *Id.*

232. Kaplan & Stromberg, *supra* note 141, at 9; *see* Hall & Woodward, *supra*, note 211, at 11 (citing Kaplan & Stromberg, *supra* note 141, at 9) ("The entrepreneurs vest in the shares upon reaching milestones in the contract. In addition, non-founder employees vest in stock options based on longevity and other factors. Kaplan and Stromberg (2003), Table 2, report on both elements of vesting in terms of ownership shares if no vesting occurs and if all vesting occurs."). *See generally*, John R.M. Hand, *Give Everyone a Prize? Employee Stock Options in Private Venture-backed Firms*, 23 J. Bus. Venturing 385, 385–404 (2008) (presenting statistical data on firms employing stock option plans to incentivize employees).

233. Hand, *supra* note 232.

234. Hall & Woodward, *supra* note 211, at 11.

235. For example, the investor may invest $100,000 in the business. The entrepreneurs have time, effort, and $10,000 invested, but own 50% of the business. Someone offers $200,000 to purchase the entire business. That would mean the investor would receive $100,000 for her 50% of equity and entrepreneurs would receive $100,000. This could be a big win for the entrepreneur, yet the business has not yet capitalized.

additional protection feature, employee equity agreements generally have some form of restriction on the transfer or sale of the equity.[236]

Lastly, investors may want any inventions by members of the business to become the property of the business.[237] Many start-up ventures survive and grow only through new internal inventions or innovations.[238] Investors may depend on these breakthroughs to drive business growth and value. Investors impose strict control rights over employees and contractors to reduce the risk of losing any invention or intellectual property.[239] This risk is most relevant where the entrepreneur is the driver of innovation within the business, but also has divergent business interests.

8. Special Rights and Protections to Investors

Other special rights and protections allocated between the parties relate to the use of representations, warranties, restrictive covenants, and conditions precedent.[240] These are all control provisions that reduce the risk to entrepreneurs and investors. The investor will require certain facts and assurances about the business that may be restated later in the purchase agreement. These representations provide investors the right to financial claims against the entrepreneur if she misrepresented the business.[241] In practice, this often includes representations about the business that are tenuous.[242] The entrepreneur for her part will want to minimize personal liability by limiting any such claims to the business.

The use of restrictive covenants varies extensively based upon the nature of the deal and the parties involved. In venture capital contracts, restrictive covenants are found within the "protective provisions" section.[243] In essence, these provisions specifically control any number of activities of the entrepreneurs or business managers. Common restrictive covenants include: protective rights of new investors in subsequent rounds; information rights concerning the extent of investor access or right to company information; provisions governing expenses and allocating transaction costs; indemnification of individuals for money lost if the deal is not consummated; provisions restricting assignment of rights or interests in the

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236. *See generally* Melisa B. Frye, *Equity-Based Compensation for Employees: Firm Performance and Determinants*, 27 J. Fin. Res. 3 (2004) (presenting an empirical analysis of common employee equity compensation plans).

237. *See* Wilmerding, *supra* note 150, at 79–80 (providing an example of a "proprietary information and inventions clause").

238. *See generally* Peter Drucker, Innovation and Entrepreneurship (2014) (explaining the role of innovation in the development of entrepreneurial ventures).

239. *Id.* at 79.

240. *See generally* Kaplan & Stromberg, *supra* note 141 (presenting an empirical analysis of the common terms employed in venture capital contracts).

241. *Id.*

242. *See* Stephen Bloomfield, Venture Capital Funding: A Practical Guide to Raising Financing 185 (2d ed., Kogan Page 2008).

243. *See* Wilmerding, *supra* note 150, at 58–61.

business; and no-shop provisions providing for deal exclusivity and restricting the ability of the business to reference this term sheet or planned transaction to other investors. While potential restrictive covenants are too numerous to list and an explanation of these provisions exceeds the scope and intent of this Article, it is important to understand the control function of covenants in these agreements.

IV. The Value Effect of Awareness of Perception During Negotiation

Cooperation among all stakeholders within a start-up venture is generally imperative to the success of the venture.[244] The state of coopetition that exists early in the investor-entrepreneur relationship may cause self-serving behavior by either party.[245] Any such behavior is detrimental to the formation of a relational contract that continues throughout the investor-entrepreneur relationship. Trust in the other party develops from characteristics of the individual,[246] and it reflects the belief that the other party will act as expected.[247] Cooperation thus allows for the efficient utilization of the human and physical capital available to the business.[248] As such, it is important to undertake measures to facilitate cooperation that will ultimately benefit both parties.

Risk perception is germane to the development of trust because the degree of perceived risk dictates the extent to which one party trusts the other.[249] Consistent with this Article's conceptual model, perceived risk creates the disposition toward inclusion of control provisions in the term sheet. Cooperation, as demonstrated through interactions between the parties, creates a feedback loop that introduces or allows for greater trust in the relationship. Risk is not constant; it involves the probability of a combination of potential occurrences that change over the life of the business venture.[250] The negotiation of term sheet provisions captures a party's perceived risks at a finite point in the investor-entrepreneur relationship.[251] While term sheet provisions are simply mechanisms to control

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244. *See generally* Sapienza & Korsgaard, *supra* note 71 (providing an analysis of numerous aspects of the investor entrepreneur that influence effective management of the firm).

245. *See* Luo et al., *supra* note 10; Khanin & Turel, *supra* note 70.

246. *See* Shepherd & Zacharakis, *supra* note 70, at 130.

247. *See* Bottazzi et al., *supra* note 63, at 1.

248. *See generally* Sapienza, *supra* note 76 (discussing the value venture capitalists add to the entrepreneurial venture).

249. Das & Teng, *supra* note 9, at 254–55.

250. *Id.* at 254 ("Risk (or objective risk) is based on the consequences or outcomes of alternatives and their probabilities. Risk can be objective because it is something inherent in given situations. . . . [P]erceived risk (or subjective risk) is decision makers' estimate of objective risk.") (internal citations omitted).

251. *See generally* Douglas W. Allen & Dean Lueck, *Risk Preferences and the Economics of Contracts*, 85 Am. Econ. Rev. (1995) (providing insight into the use of formalized provisions to capture risk preference and govern the relationship between individuals).

those perceived risks at that time, developing a relational contract that is characterized by higher degrees of cooperation can lead to increased value creation in the current relationship and in future interaction between the parties. For example, establishing or building toward a relationship contract could affect decisions about future rounds of financing. The absence of a control provision either reflects a level of trust with regard to a perceived risk or a party's failure to perceive that particular risk in the relationship. The acknowledgement and conscious exclusion of any of the control provisions explained above may signal the relational nature of the agreement.

The implications of this Article's conceptual model of the investor-entrepreneur relationship concern the negotiation of early stage term sheets. Awareness and acknowledgement of the other party's perceived risk can facilitate an efficient allocation of control in the investor-entrepreneur relationship that lends itself to a relational agreement between the parties. The effect of the efficient allocation of control through relational contracting is maximum utilization of the physical and human capital available to the business. Consistent with this Article's construct, the level of trust between the parties may be observed in the contractual or semi-contractual provisions outlining the investor-entrepreneur relationship. In turn, there is likely a correlation between the extent of investor control and the level of cooperation between the parties in the execution of their obligations to the business venture.

Conclusion

The parties to a venture funding agreement exist in a state of coopetition. The parties account for perceived risk in the entrepreneur-investor relationship through varying levels of control demanded and trust afforded the other party. The level of risk perceived by each party may differ along individual aspects of a prospective equity deal. The provisions of the term sheet delineate the subjective risk perceptions of each party to the transaction by allocating control or trusting a party with decision-making rights. When negotiating term sheet provisions, a party should seek to understand and recognize the risk perceived by the other party and attempt to afford the level of control or trust necessary to achieve a relational agreement that provides the greatest value for the parties collectively. This is a difficult undertaking; not all risk factors are readily discernable at the inception of the entrepreneur-investor relationship. Further, every negotiation or transaction is unique as to the subjective risks perceived by the parties. This fact magnifies the need to understand the risk perceived by the other party, as risk perception becomes the driver of the level of coopetition existing in the relationship.

An optimal allocation of control and trust adequately captures the perceived risk of each party, promotes cooperation between the parties and, ultimately, facilitates the performance of the business venture. Understanding of subjective risk perception of each party to the investment transaction will facilitate the objective of negotiating a term sheet that maximizes the value created for all parties.