

Venture Capital Negotiating Issues

When companies enter into negotiations with venture capital firms, there are several issues which need to be defined and agreed upon. This article describes the key issues.

Valuation. Valuation is the most prominent negotiating issues. Valuation is the price of the company in which the venture capitalist invests. Valuation determines what percent of the company the investor is buying for their capital.

Timing of the Investment. Many investors will commit a large amount of capital, but will contribute that capital to the companies in installments. Often, these installments are only made when pre-designated milestones are met.

Vesting of Founders' Stock. Like capital, investors often prefer that stock is given to company founders and key employees in installments. This is known as vesting.

Modifying the Management Team. Some investors insist that additional or substitute management employees be hired subsequent to their investment. This gives investors additional security that the company will execute on its business model. An important issue to negotiate with regards to modifying the management team is the amount of stock or options that will be issued to new management team members, as this will dilute the holdings of the founders.

Employment Agreements with Key Founders. Venture capitalists typically do not want companies to have employment agreements that limit the circumstances under which employees can be fired and/or set compensation and benefits levels that are too high. Other key employment agreement issues to be negotiated with venture capitalists include restrictions on post-employment activities and employee severance payments on termination.

Company Proprietary Rights. If the company has an important product with intellectual property (IP), investors will want to ensure that the company, and not a company employee, owns the IP. In addition, investors will want to ensure that new inventions be assigned to the company. To this end, investors may negotiate that all employees must sign Confidentiality and Inventions Assignment Agreements.

Exit Strategy. Investors are very focused on how they will "cash out" of their investment. In this regard, they will negotiate regarding registration rights (both demand and piggyback); rights to participate in any sale of stock by the founders (co-sale rights); and possibly a right to force the company to redeem their stock under certain conditions.

Lock-Up Rights. Venture capitalists may require a lock-up period at the term sheet stage. The "lock-up period" is typically a 30-60 day period where the investors have the exclusive right, but not the obligation, to make the investment. Investors typically conduct due diligence during this time without fear that other investors will pre-empt their opportunity to invest in the company.

Each of these issues is critical when raising venture capital, since the outcome can significantly impact the success of the venture and the wealth potential of the company founders and management team. Because venture capitalists are very knowledgeable regarding these issues, and have great skill in negotiating on them, companies who are raising venture capital should seek advisors who also have this experience and expertise.

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