BY TEO YI JING

CREATING A HAPPY UNION

The key to a productive and pleasant relationship between founding shareholders and venture capital investors lies in the negotiations and documentation process of the investment and shareholders agreement.

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VENTURE capital (VC) investments are often viewed by many founding shareholders (founders) as a necessary evil or a pain to bear for growth. Founders who have received VC into their companies often share horror or war stories of having to deal with the demands of their VC investors.

However, grouses are often louder than compliments, and there are also many founders and VC investors who do not experience such growing pains. In order to achieve a happy ending, this article looks into the foundation of building a productive and pleasant relationship between founders and VC investors, which often rests in the negotiations and documentation process of the investment and shareholders agreement.

During the courtship process, whether it is the founders wooing the investor or vice versa, parties often gloss over differences and seek some form of consensus in their rush to complete the investment. The aim of both parties in this regard is to be aligned to get the monies working as soon as possible by quickly documenting the agreement. As lawyers assisting with the documentation, we have been blamed as the wet blankets highlighting risks and divergences but we do take comfort that our work gets the parties thinking of the "what ifs" and "how tos" in making the relationship work.

The best way to keep the VC happy is undoubtedly, growth of the company – but how much growth is required to bring a smile to the investor? It is true that it depends on the expectations of the investor. Founders lament that investors want the sky but forget that they are the ones who had set that expectation. The seeds are often sown when painting a bullish climb of profits so as to achieve a higher valuation of the company. After all, higher expectations of profits generally do translate to more investment monies.

These profit targets or return expectations are set out in the investment agreement as deliverables of the company or the founders, and the returns to the investor are usually tied to such deliverables. In the event that such expectations are not met or the profits not delivered, a breach of such terms may cause significant financial repercussions or substantial dilution of the founders' stake.

In such a case, it will be a happy outcome solely for the investor. Instead of a "jackpot or nothing" agreement in terms of the quantum of returns to the investor whether in cash or shares, parties may consider agreeing on a minimum return on achievement of a realistic profit target and sharing the bountiful returns between the founders and the investor in the event of achieving higher targeted profits. Such returns-sharing arrangements will also seek to incentivise the founders to achieve higher returns for the investors and better financial performance of the company.

Another complaint of founders is the frequency and extent of details required from them by way of updates and reports. These reporting requirements do take time and resources away from the management of the business and may be seen as cumbersome by the founders. However, if founders can put themselves in the shoes of the investor by imagining what it is like to hand over millions to people whom they have only just met, the necessity of such reporting will become apparent. Parties can also reduce the frequency of reporting requirements by investing time to formulate a detailed annual business plan so that the founders are able to proceed with the business at their discretion so long as it is within the ambits of the agreed business plan.

It is also the norm in shareholder agreements that investor approval is required for certain agreed corporate actions of the company, usually referred to as "Reserved Matters". Founders may feel that the speed that they are able to execute business opportunities is compromised when they are required to seek investors' prior approval. Founders often live with these requirements of the investors and fail to negotiate to have Reserved Matters crafted with exceptions such that founders are able to operate efficiently without seeking investors' approval.

However, time must be taken by the founders to identify what constitutes an ordinary course of business activities or decisions, so that these exceptions can be proposed without being unnecessarily wide in order to assure the investors that the founders are not seeking a "free pass" when asking for such exceptions. Founders who appreciate a second opinion as to their decision may also view such Reserved Matters favourably when using the investors as a sounding board to their business decisions.

In the case of a company proposing financing or acquisition transactions, it will bode well to bring the investor on board early on such decisions as investors are usually experienced in such transactions and will be able to share their wealth of experience and network with the company.

Communication issues between founders and investors can lead to potential disputes. When parties assume the worse of each other in the absence of effective communication, the investment will not lead to a happily-ever-after ending. Parties may consider including a mediation clause in the investment and shareholders agreement to trigger an agreed mediation process where parties are obliged to submit to mediation. This provides the opportunity for parties to try to seek a practical solution to their differences.

In the event that parties reach a solution, the relationship of the parties can be preserved and the company may continue to prosper instead of facing a stalemate or worse, adversarial proceedings where the business is likely to be the first to suffer.

Although the chances of living happily ever after with VC investors may improve after taking into account the above suggestions, having VC investment is not a sure thing for the success of the company, as it is ultimately still dependent on the viability and sustainability of the business. However, if founders are able to create a successful business as well as co-exist with the VC investors amicably, there may well be a happy ending for all. ■

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