Industry Canada Industrie Canada

Self-Study Guide

STEP 8: Negotiate the Deal

Canada

STEP 8:
Negotiate the Deal

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8.1 Negotiate the Deal – Introduction

When an investor likes your investment proposal and the follow-up meetings have been fruitful, you may receive a "term sheet" that outlines an offer from the investor. Keep in mind that this offer is the investor's opening position — now you've got to negotiate an agreement that both parties can live with. In some cases, negotiations are painstaking, lengthy and stressful for both parties. But some advanced thinking and effective planning can help negotiations proceed more smoothly.

In This Step

You'll learn how to do some important advance preparation before negotiations take place. You will also consider how to handle a negotiation session most effectively so as to achieve a win-win outcome and avoid some common negotiation pitfalls. Step 7 will also help you decide when and how to disclose your price and point out the key elements of the term sheet and the shareholder agreement. The key concepts are explored in the pages that follow.

- Be Prepared to Negotiate
- What's on the Table
- Arriving at a Price
- A Sample Term Sheet
- How to Handle a Negotiation Session
- Understanding the Shareholder Agreement
- Action Items

The New Tech Story

Follow the fictional company New Tech Distributors Corp. (New Tech) as it pursues venture financing. This case example gives you a feeling for the "real" data and strategic decisions you'll be facing.

8.2 Be Prepared to Negotiate

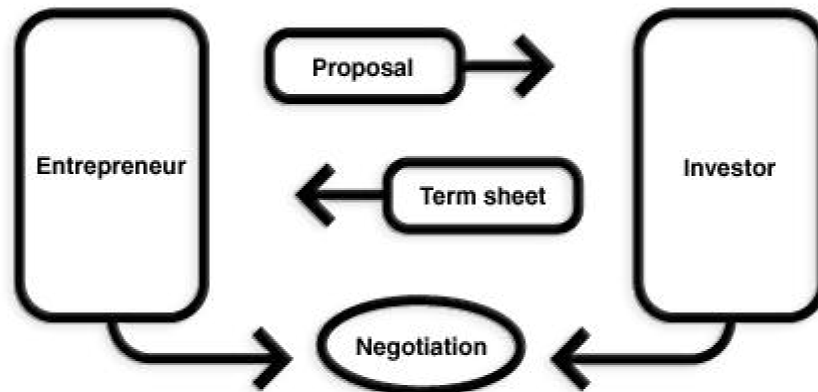
Be Prepared

You've worked hard to attract interest in your proposal. Now you've got to be ready to negotiate. Here's an overview of the process and some things to consider before the negotiations begin.

What will investors do if they're interested?

Investors who are interested in what you have to propose may respond with a counter offer. Investors will often set out the conditions of investing in a term sheet. Very simply, the term sheet is a brief document that outlines the investors' preferred terms for the deal. It sets out how much they will invest, how much of the equity of the firm they want, and

other conditions and understandings required to satisfy them. (There is more detail about term sheets later in this Step.)



What if I don't like the terms they are offering?

When you receive a term sheet, the negotiation process has begun. The first task will be reviewing the term sheet with your advisors and management team. The investor's offer and your proposal may be similar or quite different, but they will rarely be exactly the same. So it will require a process of accommodation, communication and strategy to yield a result you can both live with — the basis for a deal. Assuming you and the investor are reasonable people, and that each of you wants a deal, negotiation is how you will arrive at an investment scenario that works for both of you.

How long will the negotiations take?

The amount of time it takes to negotiate a financing arrangement will vary with the complexity of the arrangement, the motivation of the participants and many other factors. You'll probably hold several sessions over a few days or weeks before reaching a conclusion. You'll likely want to consult with advisors or your management team between meetings.

Who will negotiate the deal? Do I need an advisor?

Don't jump to the conclusion that you must negotiate the deal on your firm's behalf. Investors often use advisors during negotiations. And you should seriously consider retaining your own advisor too, ideally someone with negotiating experience. Advisors may play different roles: providing expertise on issues such as taxation, business valuation, shareholder agreements and other legal issues. In general, advisors can provide some much-needed perspective. By helping you maintain your objectivity and remove some of the emotional reactions that can result in a battle of wills, advisors can facilitate the process of getting to a deal.

What's my lawyer's role?

You'll need a lawyer for at least two reasons: to ensure the transaction complies with any applicable federal and provincial securities laws, and to develop appropriate legal documentation, such as a shareholder agreement or a lending agreement. These documents are important to the financing arrangements and may affect your company for years to come.

How can I prepare a negotiating strategy?

Take the investor's point of view: It's helpful to have some advance idea of where you and the investor may see things differently. Think about the following aspects of your proposal; how might an investor differ with your position?

- control of the key functions of the business;
- amount of capital invested;
- amount and frequency of information provided (monitoring); and
- investor's opportunities to review (and perhaps approve) your strategic plans and capital expenditures.

Learn as much as you can about the investor. Check on the investor's background and past performance. Try to take the investor's perspective to anticipate what that person will want. For more information, see *Research the Investor* in the Appendix.

How can we keep the process moving forward if we seem to be far apart?

Develop objective criteria: To get agreement on issues where you and the investor differ, develop objective criteria to measure the impact of each of your terms. Let's look at the investor's representation on your board of directors as an example. Objectively speaking, the investor may have a need for monitoring the company's progress (through a high level of board representation) while you have a need to keep control (and the board is an important element of your overall control). What criteria could you use to work toward an agreement? Perhaps you could advance the concept that the investor's level of board representation should parallel the amount of the company the investor will own. By owning 40% equity, the investor could have 40% representation on the board.

How can I make sure I don't give up what's important to me?

Know your bottom line: Identify which items you consider essential (your must-haves) and which ones you're willing to give up (your trade-offs). Now establish your opening position and also your bottom line on all major issues. Be sure to consider factors other than just money, such as control of the business over time, the value added by the investor's expertise, expanding the board of directors to include other outside directors, etc. Check with your advisors to make sure that your positions are reasonable.

Tip
The Term Sheet

Think of the term sheet as the investor's response to your investment proposal. It typically covers the following elements:

- how much the investor will invest;
- how much of that investment will be in the form of equity;
- how much will be in the form of a loan;
- details about how the loan portion of the investment will be handled;
- what type of shares the investor will receive, and what proportion this will be of the total number of shares;
- when and how dividends will be paid;
- what features the investor wants to see in a new or revised shareholder agreement;
- who will pay for expenses and fees related to the transaction; and
- any other conditions that the investor requires for the offer to stand.

8.3 What's on the Table

Negotiations can be lengthy and complex, so it's important to keep in sight the main issues that are under negotiation:

- **Price.** What is the business, and the opportunity, worth? And how much will the investor pay in exchange for a share of the business?
- **Control.** How much of the company will the investor acquire? What powers and responsibilities will the investor get, and how will they be exercised?
- **Performance Measures.** How will you, and the investor, know if your efforts are successful? What measures and targets will you use?
- **Exit Strategy.** From the investor's perspective: How can the investor get his or her money and profit out of the business? From your perspective: What's your strategy, over the long run, for ownership, financing, and operations?
- **Employment Contracts.** Will key employees be contracted to be sure they keep their positions?

Price

Price is a complex issue, based on the valuation of your business. Ultimately, the market determines the price of your opportunity, but the market is hammered out during the negotiation. You have to have a good idea of the range of values that you are prepared to accept, and the values that the investor may be considering. For more on price in negotiation, see *Arriving at a Price* in section 8.4. (Also, see Step 3.6 of this Guide for more on *business valuation*.)

Control

Until now, you've probably enjoyed 100% control over your business. You've made all the decisions to invest in equipment, lease new premises, develop new products, set budgets, etc. Relinquishing part of this control may be the hardest issue to resolve in your own mind.

Remember that most investors aren't looking to gain control of your business. Most don't have the time to run all the companies they invest in. What they do want is to receive an acceptable rate of return while limiting their risk. They have several ways to limit their risk and impose some control:

- **Requiring consultation or imposing restrictions on future decisions.** They may demand consultation before you raise additional debt equity, make capital expenditures above a certain dollar amount, increase management salaries, repay shareholder loans, or hire new managers.
- **Ensuring representation on the board of directors.** The investor may or may not want a seat on the board depending on factors such as the relative size of the investment and the current board composition. While the investor may see board membership as a way to maintain some control, you should look at it also as an opportunity to add skills and experience to your company.
- **Setting performance-based targets.** The agreement may have terms for adjusting the amount of equity you give up depending on whether or not you meet specific pre-set targets.
- **Demanding anti-dilution provisions.** To ensure that the investor's position is maintained, he or she may ask for a ban on the sale of additional shares or a provision allowing early investors to participate in future sales of equity. (Most entrepreneurs prefer the second option because it gives them flexibility to raise additional capital from new investors, if necessary.)

Performance Measures

It's important that you and the investor agree on the performance measures you'll use to determine if your business is succeeding as expected.

Performance measures may include:

- total sales volume targets;
- gross margin dollars and percentage targets;
- net income targets;
- cash flow levels; and
- debt repayment.

These measures of success may be used to determine whether, for example, you can negotiate an option to buy back equity, or whether you must give more up.

Exit Strategy

Investors want to know how they will recover their capital, and you want to be sure the timing accommodates your company's needs. So you'll have to discuss the when (the optimal term for the investment) and the how (what is the best method) of the exit strategy. Dissatisfaction with the exit provision is a key reason why investors turn down proposals. So you'll want to have feasible alternatives to consider during negotiations.

Generally, investors use one of the following exit mechanisms:

- sale of the investor's interest to a third party
- sale of your company
- buyback agreements
- initial public offering
- debt repayment

Take a Closer Look

Exit Options

Both you and the investor have to be happy with the company's long-term plans. Investors will want to be sure they can get their money out, and you want to be sure you've got options for the future. See the Appendix for more information about exit mechanisms.

Employment Contracts

These contracts ensure that key employees keep their positions, as part of the financing agreement. Legal advice should be sought in drafting the employment contract. A few common terms of a typical employment contract are:

- remuneration, including benefits and the form of compensation;
- termination arrangements, including conditions, notice period and severance;
- conditions attached to the voluntary departure of the individual from your company;
- a form of "non-compete" contract, which restricts the individual from starting a similar business or working for a competitor in close proximity for a specified period of time; and
- ownership of technology or intellectual property (if applicable).

Key Questions

Ask Yourself:

Do you want to own 70% of a potentially bigger company in five years, or 100% of a much smaller company that may not be able to grow?

Entrepreneur Stories
Which would you rather invest in: an entrepreneur driven by greed or one driven by ego? Giving up control may be hard on your ego, but can unleash growth.

Greed or Ego?
A venture capitalist once told Tony Melli, founder of Bfound.com, that there are two kinds of successful entrepreneurs: those motivated by ego and those motivated by greed. The venture capitalist noted that given a choice, he would much rather invest his money with a greed-driven entrepreneur.

- An entrepreneur who is driven by greed will make the decisions required to grow the company.
- An entrepreneur who is driven by ego will be so focussed on retaining control that he or she may not be able to attract growth capital.

Tony and his partners decided early on that they would rather own a portion of a large, profitable company than be the sole owners of a small company with limited growth potential. This realization made it easier for the team to accept relinquishing some control in exchange for growth capital.

8.4 Arriving at a Price

By now you've determined the value, or range of values, that you think is fair and accurate for the worth of your business. And in preparing for negotiations, you've established what you're prepared to give up to the investor in exchange for the investment. But though you may think you know the value of your business, the actual price will only be established as you negotiate offers with investors.

Consider how you will present your price; you want it to appear reasonable and based on proper analysis. Think about when to present the price; it's an important part of your negotiating strategy. Be sure you assess the offers you get fairly, comparing apples to apples, and don't forget to consider non-financial issues. If you're having trouble arriving at a price, there are mechanisms for bridging the price gap.

Investor's Price

Each potential investor will have a different valuation, based on his or her perception of future risks and opportunities. In general, the more knowledge the investor has about your business, the less uncertainty he or she will feel, possibly lowering the price. A variety of factors can affect the investor's valuations, including his or her:

- level of knowledge of your company's strengths and weaknesses;
- industry knowledge;
- perception of your management team;
- expected rate of return;
- negotiating strength; and

- availability of other investment opportunities.

How to Present Your Price

Show That Your Price Is Reasonable

When you disclose your asking price, you must be able to support the price in a rational and convincing manner. Usually it's best not to share your detailed calculations. Instead, provide investors with summary value calculations, a description of the valuation methodology adopted, and the key considerations and assumptions you made in arriving at the value of your company.

It may be useful to provide the investor with a summary of alternative calculations that indicate the sensitivity of your conclusions to changes in key variables and assumptions. And if you find information related to transactions involving potentially comparable companies that supports your value determination, summarize this information for the investors, too.

Work to Lower the Perceived Risk

Generally, anything that lowers the perceived risk to the investor will increase the value of your business and decrease your cost of getting funds. It's important to remember these two points:

- The right information provided at the right time can alleviate an investor's uncertainty and lower the perceived risk.
- The flow of information to the investor should continue through the negotiation process.

When to Present Price

The best time to disclose your price may vary depending on the type of investor you are approaching.

- **Inexperienced Angels**. If you're dealing with inexperienced investors (e.g. local angel investors who don't know how to price the investment appropriately), you may have decided to include your asking price in the investment proposal. Disclosing your asking price will help these investors calculate the expected return on the proposed investment. But remember that revealing your price effectively means setting a price ceiling.
- **Experienced Investors**. On the other hand, if you're dealing with experienced investors, it might be advisable not to indicate your price. These investors, who should have the expertise to value your business, could arrive at a higher value than you anticipated. If you have approached several interested investors, resist disclosing your asking price until you see what they offer.

Assessing Offers

Convert All Offers Into Their Cash Equivalency

In most cases you can expect to receive cash in exchange for a percentage of the common share equity of your company. Some investors, however, may propose instruments other than simple common share equity. In considering these, convert them to their cash equivalency (the equivalent amount of cash received today). Non-cash components of offers can include:

- various forms of equity, near equity and non-equity instruments;
- mechanisms to adjust equity participation from time to time;
- buyback rights based on predetermined prices or formulas; and
- staged payment terms.

Don't Forget Non-Tangible Aspects

When you compare the offers you receive, don't overlook important considerations that may not come with a price tag. For example, will the investor bring other benefits, such as management expertise, business contacts, other business opportunities, and the opportunity for further investment to your company? Will you be comfortable dealing with this person?

Ways to Bridge the Pricing Gap

Reaching agreement on price can be very difficult, but there are ways to bridge the gap. One common method is a ratchet clause. The underlying principle of a ratchet clause is that the entrepreneur will earn back a percentage of equity if certain targets are met and, likewise, will give up additional equity if targets are missed.

When establishing the components of a ratchet clause, ensure that the target is objective and measurable. Also establish whether the calculation will be affected by unusual income or expense items that may occur over the measurement period. Due to potential tax consequences and the sophistication of this type of financing structure, you should seek professional advice if you're going to include a ratchet clause in your financing agreement.

Tip

The market will determine the price.

And the market price is simply what someone is willing to pay.

8.5 A Sample Term Sheet

The term sheet sets out the investor's terms and conditions for participation — it's an outline of an agreement. It may be issued earlier or later in the process, but this short document is an important phase in the negotiation.

See if you can find the key elements of negotiation in the sample term sheet shown below. It's the term sheet issued by the investor Walter Buffet to the entrepreneur Stuart Chip, in our fictional case example, the New Tech story. See the Appendix for an explanation of and/or comments about the terms in bold.

Private and Confidential

June 21, 2001

Mr. Stuart Chip
President
New Tech Distributors Corp.
20 Burnaby Street
Burnaby, B.C.
V7V 2R3

Dear Stuart:

This letter will set out the terms of a proposed financing of New Tech Distributors Corp. (New Tech). Buffet Capital Corp., (Buffet) will provide $600,000 of capital on the terms provided herein:

1. On or before July 21, 2001 (the Closing) which date can be extended with mutual agreement of New Tech and Buffet, Buffet and New Tech would enter into a financing agreement whereby Buffet would purchase **$600,000 (Canadian) worth of common shares (the Shares) from treasury of New Tech representing 40% common voting in**terest of New Tech. This 40% interest shall be **non-dilutive** to New Tech except in the event of a share offering:

> (a) pursuant to a prospectus, registration statement or similar offering having gross proceeds of greater than $4.5 million; or
>
> (b) where the per share price at which the common shares are offered is equal to or greater than the per share price at which the common shares are issued by New Tech to Buffet.

2. New Tech will **use the share proceeds to fund its expansion program** including its new computer module production line and marketing campaign.

3. Buffet and the existing shareholders of New Tech shall enter into a **shareholder agreement** (Shareholder Agreement), which shall provide inter alia that:

> (a) Buffet will be **entitled to nominate and have elected at least two persons as a director of the company's board of directors**. The board will have no more than six directors.
>
> (b) Buffet will be entitled to receive, within specified periods, **unaudited interim financial statements** for each of the three-month, six-month and

nine-month periods in each financial year and audited annual financial statements in respect of each financial year.

(c) Buffet will have a 45-day ***right of first refusal to participate in any additional equity financing*** of New Tech pro rata to its shareholding on identical terms where such financing is other than conventional bank financing. Buffet will give its indication whether it will participate in additional financing within the first 10 days of the 45-day period.

(d) **The following matters require Buffet's prior approval**, which shall not be unreasonably withheld and be acted upon within 10 business days:

(i) establishment of dividend policy;
(ii) any material increase in the total compensation of any of the "key employees" (provided that any increase which is less than or equal to 15% shall be deemed not to be material) ("key employees" as defined in Schedule A);
(iii) any non-arm's length transactions over $25,000;
(iv) the appointment of any new persons to any of the top four "key positions" within the company; and
(v) any material change in accounting policy.

(e) The following matters require Buffet's prior approval, which shall be acted upon within 10 days:

(i) any material change of business;
(ii) the sale of business; and
(iii) any appointment of a new president.

(f) Where any one or more of the shareholders (the Seller) desires to sell common shares to a purchaser or group of purchasers other than other shareholders (the Buyer) and, as a result, the Buyer would, together with its other holdings, hold at least 45% of the common shares, such sale (the Sale) will be permitted only if the Buyer concurrently makes an irrevocable offer (the Tag-Along Offer) to Buffet to purchase at the same price and upon the same terms and conditions all the common shares held by Buffet.

(g) A satisfactory employee stock option plan shall be put in place within six months of closing. It shall allocate not more than 10% nor less than 5% of the New Tech stock to key employees.

(h) No shares of New Tech may be assigned or pledged without the prior approval of the board of directors.

(i) The board of directors shall periodically review acquisition opportunities to encourage growth in revenues and net income.

(j) New Tech shall state its current **intention to complete an initial public offering of its common shares by December 2004** (subject to consideration of all relevant factors at the time, including those factors relating to New Tech's business, conditions of the financial markets and the valuation of New Tech and its securities at such time).

(k) The Shareholder Agreement shall terminate on the completion of an issuance of securities pursuant to a prospectus, registration statement or similar offering having gross proceeds of greater than $4.5 million.

4. This offer is subject to the following conditions being satisfied prior to or on Closing except for 4(c):

(a) That there shall have been no material adverse change to the business activities of New Tech.

(b) That New Tech and Buffet's boards of directors shall each have approved the terms of this proposed financing on or before June 30, 2001.

(c) Stuart Chip and other key employees shall each have entered into a satisfactory **employment agreement** with New Tech to the sole satisfaction of Buffet which agreement shall include non-competition positions.

(d) Formal documentation satisfactory to Buffet and New Tech and their respective counsel shall have been completed.

5. New Tech shall be responsible for payment of all solicitors' fees and other professional fees related to the transaction contemplated herein. In addition, New Tech shall pay Buffet an earnest fee of $25,000 upon acceptance of this proposal. Reimbursement of such professional fees shall only be required to be made, and such payment to Buffet shall only be refundable in the event that Buffet chooses not to proceed to Closing based on the terms as outlined in this letter through no fault of New Tech (it being understood that in the event that New Tech and Buffet are unable to reach agreement on the terms and entitled to have such earnest fee refunded in full and shall not be liable to reimburse Buffet for payment of its professional fees).

6. Buffet will receive an aggregate director's fee not to exceed $12,000 per annum unless New Tech should otherwise agree.

7. This offer is open for acceptance until the close of business July 21, 2001.

Yours truly,

Walter Buffet
Buffet Capital Corp.
AGREED AND ACCEPTED TO THIS ________ DAY OF________ 2001

8.6 How to Handle a Negotiation Session

Let's look into the future. Imagine you've received a term sheet, and you and the investor have just sat down to discuss it. Here's how you might handle that negotiation session.

Open the Discussion

Open the floor to discussion. Briefly state the differences you see between the investment proposal and the term sheet. Suggest to the investor that it would be beneficial for both of you to discuss the reasons behind your respective positions.

Focus on Interest

In specific terms explain the reasons that led you to propose the terms described in the investment proposal. Discuss your interests and listen to the investor's. Don't seek or give justification. Instead, look for common interests to give momentum to the negotiations. Both you and the investor will likely share several interests; one could be to ensure the success of your business.

Sometimes your interests on particular elements of the term sheet will be different from the investor's. When this happens, you need to look for ways to address the potential conflict and reach an agreement that satisfies you both. Once you know the other person's interests, it's easier to see several other solutions from which to choose. There is usually more than one position you can take to meet your respective needs.

Find Common Ways to Calculate Financial Elements

Some of your figuring could be different from the investor's partly because your approaches may not be based on the same factors. If there are differences between specific financial elements such as the interest rate or valuation multiples, you may only reach an agreement on these points by discussing them further. Present your approach and listen to the investor's. Discuss each approach and agree on a method that is fair, legitimate and practical to both of you. If necessary, suggest that the two of you seek expert advice to choose an agreed upon method. Once you agree on the financial elements, it becomes easier to look for creative alternatives to a financing deal.

Create Alternatives to Benefit Both Parties

Set aside a certain amount of time to explore possibilities that are valuable for both of you. Look for options that satisfy both of your previously mentioned interests. Don't

criticize any of the proposed solutions until you have generated many ideas. Be creative and flexible. There is usually more than one right answer to the issues at hand.

In preparation for this meeting, you could brainstorm alternatives with colleagues, advisors and friends. It could help you start the flow of ideas when you meet with the investor.

Keep the Future in Mind

Remember that the deal you make on this round of financing will have an impact on the next round. When you're building a business, you may have to seek financing more than once as you grow. As a result, try to ensure that any agreements or contracts for the current investment don't overly reduce your flexibility in terms of future investment. In particular, consider whether the investor you're talking to today is willing and able to invest additional funds in the future.

Discuss Each Alternative

Evaluate the merit of each proposed solution on its own. Don't compare them to the others until you're down to very few options. Discount ideas you both think are unrealistic. Criticize constructively; focus on the ideas, not the person.

With one or a few options remaining, you should progress to finalize the agreement.

Multiple Negotiating Sessions

You'll probably hold several sessions before reaching a conclusion. Use the breaks to develop alternatives, analyse the other side's reasoning and needs, and assemble additional information to support your objectives.

Don't negotiate over the phone. This can be a dangerous way to proceed.

The 11th Hour

During negotiations most of the action occurs in the 11th hour. Use this knowledge to your advantage by keeping your concessions near the end of your scheduled meetings. Don't start off by giving in. Keep the discussion moving by switching to different elements or probing to gain more knowledge from the other side. Keep your own deadlines flexible by starting the search for financing early, ideally months before the actual cash is needed.

Select a Solution

Based on your understanding of the alternatives, select the solution most agreeable to you and the investor. Discuss the next steps with the investor to determine an immediate plan of action.

Close the Deal

When all issues are resolved, the terms are agreed upon in principle, the legal documentation is complete and the logistics of transferring the funds are decided, it's time to close the deal. Review the agreement in principle and the documentation, and sign the agreement.

Stay Calm

Control your emotions, perceptions and the way you express your ideas, needs and observations.

Be sure to take a look at our list of *Negotiation Dos and Don'ts* (in the Appendix).

Tip

Don't Negotiate Over the Phone

Generally you should avoid negotiating by telephone. Phone conversations tend to be hurried, forcing you to think quickly and not allowing you time to be thorough. As well, this approach doesn't give you the opportunity to observe the other party's reactions and body language. The person placing the call is at an advantage because he or she can be prepared. The caller will have the documentation in place, the door closed, and access to a computer, calculator and possibly an advisor. By contrast, the person receiving the call may be in the middle of a task and totally unprepared.

If you receive a telephone call from the investor intending to complete an important negotiation, you should defer the discussion until later. Say, "I'm sorry, I am late for a meeting with an important customer. May I call you later or meet with you tomorrow?" This will allow you to prepare your own materials. When you call back, you will have the advantage of being prepared while the other party is caught off guard.

Entrepreneur Stories

Innov International, a west-coast high-tech firm that successfully attracted venture capital, learned that it had to be patient and find the right mix.

In the case of Innov International, a successful deal appeared to have been near on numerous occasions, only to fall through. Several private investors dropped out due to the length of time that it took to find sufficient financing. This was one of the difficulties of putting together a deal with so many players. Innov, a Canadian high technology firm, was persistent.

Once the right private investors were found, the negotiations were relatively easy and "seemed equitable" to the founder and investors. Besides attracting three private investors, Innov obtained financing in the form of long-term debt, a provincial government equipment loan guarantee, a local development fund loan and a line of credit from its financial institution.

8.7 Understanding the Shareholder Agreement

Many of the terms and conditions that you negotiate will be set out in the shareholder agreement. It establishes the rights of shareholders and the duties and powers of the board of directors and management. You will probably need to have a new agreement drawn up, or an existing one amended, to reflect the outcomes of the negotiations.

The shareholder agreement and, in some cases, a Debenture or Security Agreement, will cover the key issues you've negotiated: ownership restrictions to protect investment, management decision-making powers, composition of the board of directors and other issues relating to the control of the company.

A typical shareholder agreement might:

- establish rights related to the sale, issuance or subsequent distribution of shares, including rights of first refusal, piggyback rights and pre-emptive rights;
- define the rights and duties of the managers;
- stipulate options to buy or sell the shares (i.e. a "shotgun clause");
- anticipate what will happen in case of death, retirement, etc., of a shareholder (the agreement should set out whether, in the case of such events, the value of the shares is to be calculated according to a predetermined formula and if the minority position of the shares in question should be considered); and
- establish the composition and duties of the board of directors.

The shareholder agreement may also:

- provide existing shareholders with the right to approve future shareholders; and
- document any exit mechanism that has been negotiated.

You'll Need Legal Help

As with any contract, legal assistance is essential for your own protection. Because of different circumstances for each business relationship, a standard or off-the-shelf shareholder agreement won't be appropriate to your circumstances. You'll have to craft a custom agreement to fit your specific needs and arrangements. An effective agreement can't be prepared without the help of an expert.

Make sure that the shareholder agreement clearly documents the intentions of the shareholders. Relationships among shareholders can and do change. Intentions and facts that are clearly agreed to by shareholders today may become areas of future dispute if they aren't properly documented.

You can find the *main components of a typical shareholder agreement* in the Appendix.

Debenture or Security Agreement

If an investor makes a subordinated debt investment in your business, there will usually also be a requirement for a debenture or security agreement. Key elements of this agreement may include:

- principal amount;
- interest rate;
- term of loan;
- principal repayment;
- security;
- financial covenants;
- activities requiring investor's consent; and
- reporting.

This list is based on: Torkin, Manes, Cohen and Arbus, "Legal Components of Venture Capital Financing" a presentation by Mr. Barry S. Arbus, Q.C., February 13, 1997.

8.8 Action Items

In this Step you learned the importance of preparing for negotiations rather than winging it. You looked at the key issues under negotiation and examined how they are presented in a term sheet. You considered some of the factors that influence price and how to handle the presentation of price during the negotiation. You covered the role of the shareholder agreement and explored how a typical negotiation unfolds.

The following checklist will help you to:

- assess your understanding of the ideas covered in this Step;
- gauge your progress; and
- plan your company's approach.

Checklist

Activities	Status	Target Date	Responsibility
Put in the time to prepare. • Investigate the other party. • Know your own position thoroughly.			
Use an advisor to increase objectivity, facilitate communication and bring you negotiating expertise.			
Determine your bottom line on all key elements of an agreement: • price; • amount of capital invested; • control (including management responsibilities and board of directors); • performance measures; • exit strategy; and • other.			
Consider what the investor will likely accept on these key elements. Look ahead for common ground.			
Develop a strategy for handling negotiation over price (consider the investor's background and how you present your price).			
Prepare yourself and your team for negotiation sessions by reviewing guidelines on what to do and what to avoid during negotiations.			
With legal assistance, pay careful attention to the shareholder agreement that will define many of the key elements you've negotiated.			

Appendix

Take a Closer Look - Research the Investor (see section 8.2)

Before you get to the negotiation table you should do some research to learn more about the investor you're becoming involved with. Talk to peers, other investors, business advisors and entrepreneurs who have been financed by this person. Be creative: your goal is to understand the investor so you can influence the negotiation process.

- What are the investor's interests, field or profession, current activities, enthusiasms, etc.?
- What kind of business partner has he/she been in the past?
- What motivates the investor?
- How were the investor's previous deals arrived at? How were they structured?

Investors' Wish List
As you know from previous Steps in this Guide, most investors are looking for:

- an adequate rate of return;
- a capable management team;
- a sound business opportunity;
- reasonable protection against unexpected developments; and
- exit strategies.

Although you have considered these aspects in previous Steps, a short review follows here.

Rate of Return
An investor's rate of return on the investment will vary with the structure of the investment (debt or equity), the nature of the business opportunity and the investor's individual cost of funds. It's not unusual for an investor to look for a rate of return, over a period of three to five years, in the range of 25% to 40% per year. You can help ease your investor's concerns by showing that your company is likely to achieve his or her expectations.

Capable Management Team
No matter how good your product or service may be, you won't be successful without a capable management team. Be open and candid with investors and expect to meet with them many times until they are confident that you can be trusted with their money.

Most investors expect a 100% commitment to the project from every member of your management team. Don't expect the investor to inject risk capital if you aren't prepared to devote yourselves completely to the success of the business.

Sound Business Opportunity
You can't rely entirely on the investment proposal to convince the investor that your business represents the best available investment opportunity. To improve your odds of receiving risk capital, you should be able to expand on the material you have provided to the investor. Put yourself in the investor's position and ask yourself: "What do I need to be convinced that this proposal represents the best possible opportunity for my investment?"

Reasonable Protection Against Unexpected Developments
Most investors want the option of having a seat on your board of directors so they will have some influence over the strategic direction of your company. They may also want to approve certain material matters, such as capital expenditures over a certain dollar amount or the hiring of key executives. Some investors may want the deal structured so they can take action to protect their investment if your company doesn't meet the financial objectives described in the proposal. The investor may require conversion privileges on convertible preferred share or debenture issues, which, if exercised, enable the investor to obtain control over your company and install new management. These requirements aren't unusual; they simply take into consideration the investor's need to minimize exposure to risk. These options help to manage risk and offer the investor an opportunity to take action (when and if necessary) to protect against unexpected developments and downside risks.

Exit Strategies
All investors want to know how they will recover their original capital. It's important to discuss the optimal terms of the investment for both parties. Also ensure that the timing of the investor's planned exit from the investment accommodates your company's needs. Investors often expect to hold their investment for three to seven years. Your negotiation plan must include a mechanism for the investor to recover his or her capital and achieve the required rate of return.

Don't assume the investor expects to remain involved with your company until you're in a position to offer shares to the general public. Only a very small number of companies eventually go public. At the same time, all investors will want to realize cash on their investments at some point in the future. Try to remain flexible on exit mechanisms because the investor may need the capital for something else in the future. Exit strategies are discussed elsewhere in this Step.

Take a Closer Look - Exit Mechanisms (see section 8.3)

Sale of the Investor's Interest to a Third Party

Minority investments in private companies are very difficult to sell due to the lack of control and liquidity. The process of bringing in a third party to replace an existing investor is very similar to your current search for capital. There will be significant costs in finding new investors, and the process may consume a great deal of time and effort on the part of company management and the investor. The process may be complicated even more if the new investor questions the current investor's motives for exiting. The person may think, "If this company is such a good prospect, why sell out?" For these reasons, sale of an investor's minority interest to a third party is not a common exit option. However, a shareholder agreement may contain a clause called a "put option." An investor can "put" shares to the entrepreneur (requiring them to be repurchased at a price based on a predetermined formula) in the event your company doesn't go public in five years, for example, or the investor can sell the shares to a third party if you can't buy the investor out.

Sale of Your Company

The outright sale of your company may be easier to accomplish than the sale of a minority investor's interest. This assumes you agree with the circumstances under which your company would be sold. The sale of your company can take time, and the investment agreement should allow for this eventuality. The sale would likely require a third-party advisor, and the selection of such an advisor should be agreed to at the outset.

Buyback Agreements

This exit strategy is used occasionally by investors. The principal notion is that the future cash flow of the business should enable you to pay back the investment over time. The buyback may take the form of a put option held by the investor, as described previously. The price of those shares will normally yield a significant return to the investor. Usually cash flow performance targets must be met before the buyback because of the need to take cash out of the business. It may be necessary for your company to obtain a new source of financing to bear the cost of a forced redemption of shares of this type. If so, you should seek professional advice before entering into any agreement that carries this type of exit mechanism.

Initial Public Offering

This exit method can be the most satisfying to both you and your investor. Depending on market conditions and the nature of your business, the value of your company's shares can be very favourable when compared to your original invested capital. Normally the initial public offering (IPO) will allow both you and the investor to withdraw some capital while increasing the liquidity of your remaining shares.

Negative Considerations of the IPO

- While there are certain benefits associated with an IPO, there are also some negative considerations when evaluating alternative exit strategies.

- The loss of a significant portion of your ownership position leaves you in a minority position.
- Your business becomes public, which forces you to share potentially sensitive information with the public.
- A portion of your shares will be held in escrow, possibly for years, thereby forcing you to remain invested.
- Frequently, for an IPO to be successful, all the money raised must be used to expand the business. Your new shareholders will want to see a plan to increase the value of their shares and may not be interested in simply providing immediate cash for you or your risk capital investor to withdraw.

Debt Repayment
This mechanism is common if the financing structure used by the investor includes subordinated debt with specific repayment terms. Subordinated debt may have equity "kickers" or participation fee features. In addition, certain subordinated debt instruments may carry conversion privileges that allow the investor to convert the debt into a predetermined number of common shares under certain circumstances, such as your company's inability to make scheduled payments of principal or interest. You should consult with your financial advisor before entering into any financing arrangements that include convertible term preferred debentures or similar debt instruments.

Principal Components of a Shareholders Agreement (see section 8.5)

1) $600,000 (Canadian) worth of common shares (the Shares) from treasury of New Tech representing 40% common voting interest

This key term indicates the price Buffet is willing to pay and how big a piece of the company he wants. Underlying it is his valuation of the company and assessment of the financial opportunity.

2) non-dilutive

These conditions are designed to ensure that Buffet's position in New Tech is not "diluted". Buffet is only willing to have a smaller percent of the company unless the value of the shares increases significantly.

3) use the share proceeds to fund its expansion program

The investor is making very clear how the money will be used.

4) shareholder agreement

The shareholder agreement is an important vehicle for establishing the relative rights and responsibilities of the investor in the new enterprise. Several key terms and conditions would be set out in this agreement.

5) entitled to nominate and have elected at least two persons as a director of the company's board of directors

The composition of the board is one way for the investor to monitor and assert some control over the business.

6) unaudited interim financial statements

The investor wants to keep an eye on his or her investment. The agreement will clarify how and when.

7) right of first refusal to participate in any additional equity financing

This is an anti-dilution provision. The investor wants to ensure that he or she can maintain his or her level of ownership through future rounds of financing.

8) following matters require Buffet's prior approval

This is another condition to ensure the investor can exercise control in the running of the company.

9) intention to complete an initial public offering of its common shares by December 2004

This is the exit strategy. The investor wants to be sure an IPO is made so he or she can get his or her investment out of the company.

10) employment agreement

The investor wants to be sure that the company does not lose any of its important management team members.

Take a Closer Look – Negotiation Dos and Don'ts (see section 8.6)

Successful Negotiating Techniques

Aim for a Win-Win Solution

A win-win solution is one in which both parties feel they have achieved a good deal. It's the best possible outcome because not only has a deal been reached, but also the deal is one that leaves both parties happy and positive. No one has hard feelings. The secret to achieving a win-win solution lies in following three simple rules.

1. Find Common Ground

Both you and the investor share a mutual interest in completing a financing deal. You need capital to grow your business, while the investor needs to place capital where it will earn a good return. The problem of finding a common ground where both of those goals are attainable is at the centre of the negotiation. Remain focussed on this issue and be flexible in negotiating to achieve this end. The worst outcome is when no agreement is reached on a deal that could have been good for both parties.

2. See the Investor as Friend Not Foe

Try to establish a longer-term relationship with the investor. Consider the investor as a partner who will further your business aims, not an adversary to be beaten.

3. Be Objective

Wherever possible, base your positions on objective criteria. For example, when negotiating the timing of the receipt of funds, set one of your criteria as the timing indicated by a cash flow model with mutually acceptable assumptions. This will eliminate the need to bargain over minor points, such as timing discrepancies between your need for all the money at the outset and the investor's desire to inject funds over three years. Both parties will be able to understand the objective criteria, and neither will lose face by accepting a compromise from the original position.

Handling an Adversarial Negotiator

An adversarial stance is simply a negotiation tactic. The investor may want to be seen as a hard bargainer. The outcome of this type of tactic is often a lose-win situation (where one person gives in to accommodate the other). Aside from the fact that you lose in this situation, this outcome is negative for another reason: it's not a good basis for building a long-term relationship.

The most effective way to deal with an adversarial bargainer is to turn the discussion to the problem or objective. This can be accomplished by:

- acknowledging the other person's position;
- using probing questions to gain a clearer understanding of the person's motivations and reasoning;
- giving alternatives and explaining their features and benefits;
- checking with the other person to gain feedback and determine if your alternatives have satisfied any objections; and
- ensuring (rather than assuming) that the issue has been resolved.

Common Negotiating Pitfalls
Here are some common mistakes:

- poor or inadequate preparation;
- asking for unrealistic terms at the outset, which affects your credibility;
- playing with the truth and underestimating the other party's abilities to perform the due diligence review;
- unrealistic expectations about your product's sales potential (investors refer to this situation as "hockey stick" growth expectations where a graph of sales growth versus time looks like a hockey stick);
- being too accommodating to the other party just to close a deal (be prepared to walk away from an unfavourable deal);
- ignoring or not trying to understand the other party's position and needs;
  failing to listen carefully to the other party, resulting in your assuming an issue is resolved when it isn't (this will cause friction later in the negotiation when the issue resurfaces and may result in your inability to close the transaction);
- establishing a position that will be impossible for you to back away from without losing face (for example, by refusing to give up more than 20% of your company, your flexibility is severely compromised, and sticking to such a rigid position may not give either party enough room to arrive at a mutual agreement);
- beginning negotiations too soon or before the other party's interest and understanding of your opportunity is fully developed; and
- assuming you have no leverage (remember, the other party would not be there unless he or she could gain by doing business with you).

Take a Closer Look - Principal Components of a Shareholders Agreement (see section 8.7)

1. First Rights of Refusal of all Shareholders

- Any selling shareholder shall offer the other shareholders, on a pro rata basis, the first right of refusal on the sale of the shares.

2. Piggyback Rights

- If any shareholder wishes to sell shares to any person, then such a sale will be conditional on the buyer also making an offer to all other shareholders at the same price and condition.

3. Pre-emptive Rights

- A shareholder shall have the right to subscribe for any new treasury shares on a pro rata basis with existing shareholders.

4. Rights of an Initial Pubic Offering

- Any distribution in a public market in Canada and the United States will be done on a proportionate basis among all shareholders.

5. Non-Assignability or Transferability of Shares

6. Board of Directors

- The composition of the board;
- Decisions requiring approval of the board such as capital expenditures, assumption of debt, acquisitions;
- Number of meetings of the board of directors for each fiscal year; and
- Directors' fees and reimbursement of expenses for traveling to board meetings.

7. Life Insurance on the Senior Management of Your Company with Your Company being Beneficiary

8. Put Option

- If the corporation does not go public within five years, the investor has a put option to put its shares to management at fair market value (as defined) or cause the corporation to be sold to a third party within six months of the put being tendered if the majority shareholders cannot fund the transaction; and

- If the investor does not exercise the put, the other shareholders will have a call subject to guaranteeing the investors their minimum guaranteed rate of return.

9. Directors Indemnification

10. Shareholders Approval Required to Certain Major Actions of the Corporation

- Creating subsidiaries or acquiring shares of any other corporation;
- Winding up;
- Sale or transfer of assets having an aggregate value exceeding a specified dollar amount;
- Mortgaging or pledging assets of the corporation other than those secured to corporation's bankers;
- Declaring dividends;
- Undertaking any material change in the business of your company;
- Acquiring assets for more than a specified dollar amount in one transaction;
- Guaranteeing liabilities of third parties;
- Changing the number of directors;
- Issuing any options or warrants;
- Authorizing a management or employee stock option plan; and
- Changing the corporation's fiscal year end or changing auditors.

Source: Torkin, Manes, Cohen & Arbus, "Legal Components of Venture Capital Financing," a presentation by Mr. Barry S. Arbus, Q.C., February 13, 1997.