

Heard on the Listserve (August 2007): Founder Indemnification in VC Financings

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Since our last meeting, the Listserve has been very active. Among the discussions was a vigorous back and forth regarding founder indemnification. The discussion was kicked off by Andrew Hoyne on March 2 with the following post:

“ . . . do you ever see situations where founders of a VC-backed company personally (not as a corporate officer) rep and warrant the condition of the company as part of the venture financing, and personally agree to jointly and severally with the company indemnify the claims of investors for breaches of such reps? I am not concerned with a start-up . . . but instead am interested in your comments re a later stage financing round.”

Andrew received a number of detailed responses, with answers falling on both sides – with some differences apparently based on geography and company side v. investor side representation.

Chip Lion and Dimitry Herman both noted Footnote 40 to the NVCA’s Model Stock Purchase Agreement, which is generally in line with the responses from the Committee members and states:

“Founders’ representations are controversial and may elicit significant resistance. They are more common in the Northeast and counsel should be warned that they may not be well received elsewhere. They are more likely to appear if Founders are receiving liquidity from the transaction or if there is heightened concern over intellectual property (e.g., the Company is a spin-out from an academic institution or the Founder was formerly with another Company whose business could be deemed competitive with the Company). Founders’ representations are not common in subsequent rounds, even in the Northeast, where risk is viewed as significantly diminished and fairly shared by the investors rather than being disproportionately borne by the Founders.”

Common Themes.

While the responses varied in many respects, some consistent themes emerged.

Founder Liquidity. First, most of the responses viewed the situation in which founders are experiencing a liquidity event in connection with the financing as a special situation where personal liability may be more prevalent or appropriate. For example:

“I’ve seen this only once in a deal that actually closed, and in that case the founders were taking money out of the company in connection with the round, and the new investors asked them to escrow a portion of their personal proceeds against an indemnification obligation.” (Marc Leaf)

“I agree with Marc. An indemnity is market where the deal presents some liquidity to the founders or other investors. This is not common in the venture context, but very typical in the private equity context.” (Dimitry Herman)

“In my 25 years of practice only twice have I seen a founder (who was not taking money off the table) indemnify and hold harmless the investors for damages from the breach of reps and warranties of the Company and I think the investors were misguided in their demands.” (Chip Lion)

Intellectual Property Concerns. Second, a number of the responses mentioned the importance of intellectual property in this equation. For example:

“If a key company asset is intellectual property such as software code developed by the founders, and the founders previously worked for another company and did similar work but left to start the company, then a rep as to the software not incorporating code developed while employed at the prior firm is, in my opinion appropriate (and often obtained).” (Robert Webb)

“I agree that these Founder representations are exceedingly rare in later rounds. However, there can be such personal representations regarding *no violation of any IP obligations to prior employers*, no person litigation (historical or pending), no personal arrangements regarding voting of shares, no prior violation of any laws, etc. This helps avoid some of the pie in the face scenarios for investors (assuming the Founder making the reps is going to be honest).” (Neil Aronson) (emphasis added)

Differences in Practice Based on Geography. Additionally, consistent with the NVCA commentary and (I’m sure) the experience of most of our Committee members, differences on this issue surfaced based on geography, with attorneys on the West Coast falling more squarely against founder indemnification and attorneys on the East Coast seeing them more frequently. Following his comments quoted above, Chip (who is based in California) noted that “I understand that practitioners on the East Coast may have a different experience and a different view.” Dave Felman (who is based in Florida) shared his view that “Chip’s response is consistent with the position on this point often taken by California counsel . . . We see founders’ representations in earlier stage deals.”

Analysis of the Issue and Compromise Positions.

A number of the responses provided helpful analysis and suggested possible compromise positions.

Analysis. Samantha Horn replied that she has seen the request before and would resist it in all circumstances. Samantha provided the following reasons for arguing why a founder should not have to provide personal representations and warranties:

“The reason for establishing a corporation is to ensure that the liability of the founders is limited to the money invested in shares of the company. Below is a list of reasons I have given to a founder to argue why they should not have to personally rep and warrant.

- not in the term sheet – very crucial business point – had you known this would be requested, you would have proceeding with funding from another source
- it’s a terrible precedent for subsequent financing rounds (you’ll never get off the hook)

- is not something provide in most deals
- you have past experience that they know about
- they have due diligenced the deal and know they risk
- what's the point of incorporating if you end up having to risk personal assets
- if this becomes standard, individuals will simply judgment proof themselves”

Neil Aronson added “I agree with your point that if you want to go this route, you need to state so in the term sheet.”

Compromise Positions. The responses also evidenced compromises that are common on this issue. These compromises consist of limiting the founders’ personal liability through various mechanisms.

Dave Felman noted “The parties often compromise by limiting the representations to the founders’ knowledge. The point is not recourse to the founders (which makes for a tough relationship), but rather to ensure that founders pay close attention to the representations and accompanying disclosure schedules.”

Dimitry cited the NVCA approach. The introductory paragraph of Section 3 of the NVCA’s model Stock Purchase Agreement states:

“ . . . [(it being understood and agreed that any Founder’s liability for breaches of any provisions of this Section 3 shall be limited to the then current fair market value [as determined in good faith by the board of directors of the Company] of the shares of Common Stock of the Company currently owned by such Founder and such Founder [may, in his sole discretion, discharge such liability by the surrender of such shares or the payment of cash] [shall discharge such liability by the surrender of such shares] and will terminate on the earlier of (i) [one year/two years] after the date of this Agreement, or (ii) the completion of an initial public offering of the Company’s Common Stock)] . . .”

Michael Hawthorne responded “If you have to give it, put in a cap on the exposure (something I have said is it is the shareholder percentage interest in the company – e.g. if the rep liability cost \$100 and the shareholder owns 30% then his liability is \$30).”

Additional Views.

William Hay, in Hong Kong, provided the following international perspective:

“I have seen shareholder-level indemnities in certain deals in places in Asia where international VCs are investing in existing, often family-controlled businesses. In jurisdictions where local law does not always provide an adequate remedy for fiduciary breaches, or where malpractice is not uncommon, these indemnities can help investors get comfortable with existing management. In one case in which I was involved, the investor was able to prevent the controlling shareholder from selling his shares in breach of a tag-along right because the controlling shareholder’s

shares were pledged to the VC to secure a warranty not to breach the shareholders' agreement.”
