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Some Terms are Off Limits – Even in Down Markets

As the emerging down market takes hold in the high risk/reward entrepreneurship and investing sector, entrepreneurs will see a lot of developments in the venture market that they don't like. Valuations will decline and various deal terms will shift from entrepreneur-friendly to investor-friendly. As in any down market, a lucky few entrepreneurs (and it will be mostly a function of luck) will find themselves in a post-pandemic investing sweet spot. Most, though, will experience some painful adjustments as the market sours.

All of that said, even those entrepreneurs most affected by the turmoil in the venture markets should be wary of investors peddling two particular poisons that are never "market" even if every so often they may have a place. Those terms would be: (i) cumulative dividends and (ii) ratchet price (anti-dilution) protection.

Cumulative Dividends

Very few startups have any foreseeable plans to pay dividends. Even those few emerging companies that might generate cash as they grow mostly figure on plowing that cash back into the business to finance more growth. Microsoft, for example, didn't pay its first dividend until 2003, and Amazon has never paid a dividend.

That said, most venture-backed emerging companies have some sort of "blocking" dividend provision in their charter documents. While the exact structure may vary a bit, these provisions are mostly about making sure no dividends are paid unless they are preferentially paid to the investors. Crucially, these provisions provide that dividends are only payable if and when the Board of Directors declares them. Absent such a Board declaration, they are not paid, *and they do not cumulate*.

A cumulative dividend, on the other hand, accrues to the benefit of a shareholder/investor whether or not it is declared. So, for example, if the holder of Newco Series A Preferred paid $1 per share, and the Series A has a 10 percent annual cumulative dividend, the investor is entitled to $0.10/share in dividends every year. *If for whatever reason that $0.10*

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dividend is not paid, the amount is added to the Series A liquidation preference. Which is to say that, if the company is then liquidated or sold, the Series A holders' preference payment will be $1.1 million rather than the $1 million it actually invested.

That might seem a modest figure, but consider that most startups don't exit for at least five years, and most startup exits are not home runs, and you'll see that the impact of cumulating dividends can get out of hand pretty quick. In sideways exits, even a few years of cumulating dividends added to the investor liquidation preference can be a big deal for the common shareholders lined up behind them.

As noted, cumulative dividends seldom make sense in the high risk/reward startup space. When they do, it's not because of market conditions, but rather deal-specific circumstances. More particularly, cumulative dividends might make sense where the startup is likely to be generating cash in the near term that it won't want to reinvest in the business. I recall seeing a deal like that maybe once in 35 years in the business.

One footnote. If an investor asks for cumulative dividends in a situation where near-term, predictable free cash flow isn't in the picture, that could be a sign that the investor is worried that the founding team is not fully-committed to an exit – i.e. to generating liquidity for investors. If so, the solution is usually not a cumulative dividend provision, but addressing the underlying concern head on. And perhaps even thinking about a redemption provision as an alternative (though such provisions can themselves be very problematic).

Ratchet Anti-Dilution Protection

Anti-dilution "price" protection is a peculiar concept that only venture capital investors could love. The notion is that if Investor A pays $X for a share of Newco stock, and Newco subsequently sells Investor B a share of stock for some lesser price of $Y, Investor A's price should be, in effect, retroactively reduced. Sort of an insurance policy against making a bad investment decision, financed by the rest of the shareholders (founders, employees, etc.).

(Seriously, I've heard the rational for price protection. When I was wearing my black VC hat, I even made it now and again – and in any event always got it. But, even wearing the black hat it was a hard argument to make without blushing.)

There are two basic varieties of price protection. In "formula" price protection, the effective price in the $X/$Y example above would be reduced to something between $X and $Y dollars, with the amount of reduction based on the size of the $Y investment relative to the capitalization of Newco. The bigger the relative size of the $Y investment, the bigger the price reduction for the $X investors. In "ratchet" price protection the effective price would be reduced to $Y regardless of the size of the $Y investment (i.e. even if only one share was sold for $Y).

Now, the thing is, while formula price protection is of dubious propriety, ratchet price protection is frankly corrupt. Suppose investor A buys 1 million shares at $1 each for a 1/3 interest in Newco, and investor B than comes along and buys 1 share for $0.01. With ratchet price protection, Investor A's effective price would be reduced to $0.01 per share. With that reduction, Investor A would own something north of 99% of Newco. That outcome defies not just common sense, but even the most elementary notions of fair play.

In fact, ratchet price protection is exceedingly rare – in any kind of market. It usually rears its vile head in deals where the investors have exceedingly low opinions of management across multiple dimensions. I have not seen many deals with ratchet protection, but all of them were ugly. Market conditions be dammed: don’t go there.

The Limits of Down Markets

As the market turns, entrepreneurs will have to confront a lot of unpleasant realities, including investor-friendly shifts in valuation and other deal terms. There are some terms, though, that just aren’t couth in even ugly markets, and cumulative dividends and ratchet price protection are at the top of that list.

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