Ethics Pays in the Long Run – A

By

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Instructions for the instructor: Divide the class in two groups – Venture capitalists (VCs) and Entrepreneurs. Provide the VCs with the VC note and the entrepreneur with the entrepreneur note. Give students about 10 minutes to read the case and another 10 minutes to discuss amongst their respective groups how they plan to negotiate with the other group. After this time pair up one student from the entrepreneur group with one student from the VC group. Let them negotiate the deal for 10-15 minutes. Have them record the deal in the "Deal Record" sheet (attached to the case). Collect all deal records, and compile and discuss the results.

As you are showing them the results, discuss with students why they accepted or rejected the deal and how they arrived at the terms of the deal.

Round 1 – VC:

Background: As you board the plane back to the U.S.—a trip in which you secured the final amount of funds from limited partners to close another round—the entrepreneurs with whom you have met over the last few months come to mind. You consider Tom Archin, an eager entrepreneur with a high-growth technology venture valued at $10 million. In your last meeting with him, he indicated that he was willing to offer a 50% stake for $5 million in funding. However, it may be possible to negotiate an 80% stake for the same amount of funding. All the resources to which you have access will become his own and relieve some of his burden. Tom is new to the startup dynamic, and he expressed concern about his dwindling supply of cash. Another option briefly discussed in previous meetings was 30% for $5 million. Tom said this amount would be enough to finalize contracts with manufactures and customers and push the business into the next phase of growth. He also expressed confidence that he and his small team could handle the work. You also know that there is quite a bit of buzz around his venture and that he has been meeting with other VCs in the last few months, making you all the more interested in partnering with Tom. This could be the beginning of a new era for your firm. The last round of investments did not go as well as expected and many of the limited partners were upset about the small returns they received. If you are able to get an 80% stake you will more than compensate your bad past performance, however, this may seem unfair to the entrepreneur. On other hand, Tom stands to make a few million even if he gives away the 80% stake. You telephone Tom and set up a meeting for Tuesday morning (two days from now).

Day of meeting (VC): Still feeling the jetlag from your overseas trip, you awake and realize you overslept. The meeting you set up with Tom is in 30 minutes and there is no way you will make it to the office in time. Your partner, George, is in town and you call him to see if he can make it to the office in time for the meeting while you make your way there. George says he is already on the road and can start toward the office, so you give him the background on Tom and his business. You mention, “This is the 80/20 deal I was telling you about.” George responds excitedly, “I’ll be there.” The sense of urgency now diminished, you take your time readying yourself. You go over a previous discussion you had you George about this deal and think that you will be able to convince Tom that he needs the support network you can provide and that it will be worth 80% of the company. You get in the car and begin to return messages. All of your inboxes are full and you use times like these to return messages. You arrive at the office to find George just getting out of his car. He hands you a cup of coffee and says, “I was going to be late anyway, and the coffee shop was on the way.” You smile and thank him as you walk into the office together.

<u>Round 1 – Entrepreneur:</u>

Background: A call you have been waiting for came as you were debating whether or not to call your business an unachievable dream. It was Paul Marnot, General Partner of Kalos Ventures, requesting a third meeting to discuss the details of a term sheet. You have been meeting with venture capitalists for months, and several times you were able to secure the much-desired second meeting. Despite promising encouragements, you often never hear back from these seemingly interested investors. When the meetings first began, there were some negotiations you walked away from because you thought you could get a better deal. You felt you had some negotiating power because your business was the talk of the investor community, and VCs were asking you for meetings. However, at this point, you'd probably be willing to offer 80% of your business to any investor for the $5 million in funding that you desperately need, even though you don't need anything more than monetary funds. The anxiety of seeming to come so close, and in some cases, sharing proprietary information, has become unbearable. Earlier this evening, recounting those first meetings, you wondered whether you were too presumptuous in negotiations. "Maybe I was too confident?" you thought. You used your seed money responsibly. You proved your concept, built a customer base, and generated sales. "We are solving a real problem", you thought again. You thought about giving up majority control of your company and wondered if your current employees would be fired. "Would I be fired?", you thought. As your eyes wandered around the room, they landed on the clock. It read 3:00 am, but all you could hear was the ticking of the second hand.

Day of meeting (entrepreneur): You arrive at Kalos Ventures office 10 minutes early. The receptionist checks you in and tells you that Paul has not yet arrived, but seats you in the conference room and offers you a beverage. Before you could respond, she lists the several options: cappuccino, latte, coffee, water, juice, etc. "We have a barista in the office," she says wide-eyed. Astonished by the complexity of the beverage list, you politely refuse by saying you just had breakfast. She nods her head and says that Paul will be here shortly. As you sit and take in the room, you are amazed by the lavish ambience. The chair you are sitting in must have cost at least $5,000 and there are eight of them around a table that must have cost much more. There is an abundance of artwork on the walls, which is odd because the room is relatively small. This is not the first time you have been to the office, but it is the first time you have been in this conference room. It is pristine—as if the room has never been used. It seems out of place with respect the look of the rest of the office. As a venture capital firm, the entire office is nice, but this room seems to be worth 10 times more than the rest of the building. You come out of your thoughts and realize 20 minutes have passed. "Maybe I should have placed an order with the barista", you think. Another 20 minutes passes before you hear the door opening. It is Paul and his partner George, both with coffee in hand. You were not aware that George would be there. After introductions, you begin pitching your business. George is making direct eye contact with you the entire time, while Paul seems to be answering messages on his smartphone.

<u>Deal Record</u>

Company Invested______________________________

Funding in USD__________________________________

Percent Equity Stake____________________________