# Silicon Forest Forum

## Advanced Technology Management Conference

**Silicon Forest Forum 2003 – Session 1**
**Technology Company Financings**

## MONEY ROAD-SHOW...GETTING THE STORY RIGHT

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Money Road-Show ("***MRS***" or the "***Company***") is an online integrator of financial services. The Company packages mortgage loan, insurance, accounting and financial advisory services for individuals on a single, seamless technology platform. Direct customers are personal financial tax planners, accountants and advisors to individuals ("***Money Professionals***" or "***MPs***") who subscribe to the MRS platform for a personalized webpage. Each MP selects the services offered by MRS' strategic partners/suppliers – and offers these services to the MP's clients on the MP's customized website hosted on the MRS platform. MRS' revenues come from hosting/subscription fees, and commissions on services sold on the MP websites. MP websites can be customized for each MP to include automated tools, client reports and data, communication tools and transaction processing. MRS competes in a crowded market space, with analogous service packages and platforms offered by competitors. Margins are tight, and service distinction is established by partner affiliation and pricing.

The Company was formed in 2000 by Scott McFeeley (the CEO), Thomas Edison (the CTO) and Thomas Feibel (the VP of Marketing and Sales). The Company has raised an aggregate of $60m in 3 rounds from a mix of venture and strategic investors – including Steve Furtiveson of the venture fund Caper Kisser Furtiveson; Anne Whineblad of Whineblad Bummer; and Charles Schnob of Schnob Financial. The Company has annualized revenues of $5m in 2002, it has a monthly cash burn of $500k – which is the minimum expense level needed to sustain current operations, and the Company is losing $1m/year. The Company has done 2 layoffs, and its current headcount is 30. Management believes the Company is 12 months away from profitability – and the Company now wants to raise $5m to continue current operations and expand the Company's partnering affiliation program and direct sales efforts. MRS has cash to last another 4 months, and current investors have not committed to do the round.


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## *Act One – What's the Script?*

Since its inception in 2000, the Company has obtained and packaged mortgage brokerage services provided by West Coast Brokerage. West Coast has annual revenues of $10m, is marginally profitable, a staff of 45 agents....and like MRS, West Coast has many competitors and a critical need to distinguish its services. MRS represents 10% of West Coast's revenues, and West Coast represents 40% of MRS' revenues. Scott McFeeley believes it would be advantageous for both companies to merge into a single entity. MRS would lock in a critical service vendor through backwards integration, off-line brokerage revenues would diversify revenues and MRS could begin to position itself as a more traditional financial services institution not tied solely to the internet services platform. McFeeley would like to complete the merger before pursuing the financing...in the belief that MRS would then be more attractive to new investors. To vet the idea, McFeeley has spoken with Charles Schnob, who is not enthusiastic. Schnob is concerned that the cultures of the two organizations may not match, that the infrastructure costs of West Coast's business would burden certain efficiencies in MRS' services platform, and that MRS' acquisition of a mortgage brokerage business would harm the growth of the Company's partner affiliation program with service vendors that have a competing mortgage brokerage business.

1 McFeeley and Schnob are both trying to be candid in their assessments of the West Coast merger, neither has a hidden agenda, and each is convinced he is correct. Is there any practical way to get early feedback on the integration and partner acceptance issues that Schnob has raised? How can McFeeley gauge new investor reaction to the idea when (i) the merger has not yet occurred, (ii) given the 4-month time period before Company funds are exhausted, and (iii) without burning a bridge to prospective investors who may not like the idea? Can an acquisition followed by a financing realistically be completed within 4 months? If not, what about shelving the idea until after a financing....and what does the Company say to prospective investors?

2 Neither McFeeley nor Schnob have yet spoken with anyone. In fact, McFeeley has not even approached West Coast. Should McFeeley get Board input and approval before talking to West Coast – or speak with West Coast first to see if an acquisition is feasible? What about the risk to the West Coast partnering relationship...which represents 40% of MRS' business? If McFeeley and Schnob disagree, how should each approach the Board? How can the Board review this issue, and is this analysis something that management or a committee of the Board consisting of outside directors should review?

3 McFeeley determines that he must approach West Coast before seeking Board approval so that he can confirm to the Board that West Coast is interested in an acquisition. West Coast confirms its interest in being


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acquired provided that its shareholders hold 66% of the merged entity in an exchange of shares transaction. As background, both companies are private, and West Coast's revenues would constitute 2/3rds of combined revenues. Further, MRS' post-close valuation in its last financing that occurred 12 months ago was $15m. West Coast has never done an outside financing, but 3 months ago it was valued at $30m by Alliance Partners, a regional M&A and valuation firm, in an acquisition that failed due to uncertainty caused by the onset of war in Iraq. Does the 2/3rd – 1/3rd equity split make sense? Does it matter that MRS is acquiring West Coast and not the reverse? What valuation methodologies should be used here? Does valuation even matter if both companies need the merger to survive? Should the parties engage an investment banker to work this out? Should there be private discussion among the Board members of each company?

4. After signing an LOI, West Coast determines it its diligence review of MRS that, in the opinion of its IP lawyers, MRS' transaction processing software engine may be infringing a patent held by IBM. Gordy Fameison of Henpecked & West, a respected national law firm and the Company's outside counsel, has looked into the matter and determined that in its view there is no infringement. In subsequent financing discussions with new investors, given the view of Henpecked & West, is the Company obligated to disclose the patent concern raised by the West Coast lawyers? If it is obligated, when should the disclosure be made, and how should it be presented? If IBM has not raised any issues with the Company on the patent, should the Company pre-empt the matter by contacting IBM? For a substantial amount, MRS can license an alternative transaction processing package from another software company to replace the software that may infringe the IBM patent. If these additional license fees will push profitability out from 12 months to 18 months, should MRS nonetheless license the new transaction software? If revenues from on-line transactions currently represent 15% of MRS revenues, is this patent infringement issue material to an investor's decision to invest?

## *Act Two – Who's in the Cast?*

In the Spring of 2002, the Board decides to terminate Thomas Fiebel as the Company's VP of sales for cause as a result of Fiebel (i) failing to identify for the Board certain trends in competitive pricing that have resulted in customer churn and lower growth in expected revenues, and (ii) planning and forming a new company offering on-line estate planning services to individuals. Fiebel hires a lawyer who argues that Fiebel's termination was unfair, unfounded and without cause, claiming that Fiebel was terminated because he and the Board disagreed about pricing...and not for a failure to spot pricing trends....and further claiming that the new company was not competitive to MRS, and not a corporate opportunity. In the Fall of 2002, the Board terminates Thomas Edison for cause resulting from disagreements between Edison and Steve Wosniack, the


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Company's new VP of Engineering, on the future product roadmap for the MRS technology platform. On hearing of his termination on Friday the 13th, that night after normal working hours Edison returns to the office and removes all of his office materials, including some materials containing technical plans and early designs for new application tools for the MRS platform. On the advice of his counsel, Edison then offers to return some of these materials to the Company...but at a time convenient to him and at his lawyer's offices. McFeeley is outraged at these conditions, and insists that materials be returned immediately at the Company's offices. The parties cannot agree, and the materials are not returned. All of the founders, including Fiebel and Edison, signed agreements under which they receive 6 months cash severance and 100% acceleration of vesting on their shares on termination without cause.

Should Fiebel have been terminated for cause? What about Edison?

2. Fiebel and Edison are coordinating their claims against the Company, and the lawyers for each have sent written demands for severance and acceleration to Fameison. It is apparent to Fameison from discussions he has had with these lawyers that Fiebel and Edison are particularly upset at McFeeley, believing that he has orchestrated their termination in an attempt to ingratiate himself with the Board and get an award of their shares. Who should Fameison talk to, the Board or McFeeley? While he was employed, Edison was close to Anne Whineblad – and McFeeley trusts Steve Furtiveson. Does this make a difference? Is it best to settle these claims so they are not an issue in the financing....or wait if the Company thinks it can prevail on the merits?

3. Edison and the Company are fairly close on settlement. While these talks are going on, the Company accepts a term sheet from the existing investors that provides for a 10-to-1 dilution of the existing shareholder base, and new option grants to the continuing employees so that they are not diluted in the round. Edison and Feibel are existing preferred shareholders from earlier rounds, and they have been given a right to invest in the current round to maintain their equity percentage as preferred shareholders....but again they will be diluted significantly by the new option grants for continuing employees. The existing investors, who are on the Board, believe the new option grants are needed to incent the employees.....but Edison and Feibel claim the Board has breached its fiduciary duty to them as, in their view, the grants are excessive. Who is right? Does it make a difference that the employees have been informed about the new grants? Does it make a difference if McFeeley is getting most of these new grants, as they are allocated on a pro-rata basis to employees...and he is the largest holder of employee shares? Does it make a difference if this is a traunched deal, and the 1st traunch has already closed?


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4. Edison and Feibel are essentially using the financing as leverage to cause the Company to settle. Is this OK? Should the Company consider filing for a declaratory judgment to settle the capitalization? What about filing counter-claims of interference, anti-competitive behavior and breach of contract...is there any point to this?

5. Goldman Rats Ventures, the venture capital arm of Goldman Rats, a New York based financial services firm, is a limited partner in Caper Kisser Furtiveson. Given GRV's expertise in financial services, Furtiveson's partners require that GRV invest before RKF can commit. If RKF doesn't invest, then neither will Whineblad Bummer – and the syndicate will fall apart. Vinod Khoslove at GRV likes the Company and will commit to the investment – but he is concerned about the fiduciary issues raised by the ex-founders, and he has demanded that the continuing employee option reserve be reallocated. McFeeley and Wosniak, as the most senior members of the management team, refuse to cave in to the demands of the ex-founders – and they want to reject GRV's investment. McFeeley is independently wealthy, and he is prepared to personally invest the amount necessary to make up for the lost GRV allocation. Furtiveson pressures McFeeley to change his position...as RKF can't invest if GR is not part of the syndicate. Who is right and how should this be resolved? What should Whineblad's position be in all of this? What if the continuing employees have already been told about the reallocation of the post-close shares? Even if the employees are counting on anti-dilution protection on their shares, is this protection necessary in this market to incent employees? If the Company only needs one more round to become cash neutral, and McFeeley will make up the GRV funds...should Whineblad Bummer invest and either make up the lost RKF funds or require the Company to come up with a new budget to reduce the capital needed in the round?

***Act Three – The Advisor Behind the Curtain....***

McFeeley feels a bit overwhelmed by the complexity of the round...and seeks counsel from John MacBeth, a CEO mentor that has ties to Monopolistic Enterprise Associates (*"MEA"*), the largest private venture fund in the country. Gordy Fameison has worked with MacBeth in other companies, and introduced MacBeth to McFeeley.

Both McFeeley and MacBeth want to keep their discussions private, and not inform the Board that MacBeth is advising McFeeley. MacBeth approaches Fameison and asks if he can bill the Company for his services through Henpecked & West to avoid the need for Board awareness or approval of a MacBeth's role. Fameison wants to build his relationship with both MacBeth and MEA, approves the billing arrangement – and recommends to McFeeley that he begin work with MacBeth under these


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terms. What issues does this raise? Is Fameison providing good advice to McFeeley? Is Fameison conflicted...and who does he owe his duty to...McFeeley or the Board? If Fameison owes a duty to the Board as the representative body of the shareholders...is he violating that duty by counseling McFeeley to get some outside advice? Does the Board have a right to know about MacBeth? Is MacBeth handling this in the right way?

2. MacBeth advises McFeeley that the Goldman Rats/Caper Kisser alliance is not good for the Company. MacBeth is concerned that Goldman is interested in investing primarily to get the Company's investment banking business...and that it may increase pressure on management to seek a liquidity event before it is in the best interests of the Company to sell out. MacBeth also believes it is in the best interests of the Company to replace Goldman and Caper with washout funds from MEA...as MEA has more funds available for future rounds, and it is better positioned to bring new accounts to the Company as it has extensive investments in financial services, and it is unaffiliated – unlike Goldman Rats. Are these legitimate concerns? Is it appropriate for MacBeth to be advising McFeeley to dump current investors, even if MacBeth's reasons are sound? What about MacBeth's affiliation with MEA? What if Fameison, the Company's lawyer, becomes aware of this advice? Should MEA want to invest in the Company under these circumstances? What will this do to MEA's reputation in the venture community, and should they care?

3. Should McFeeley take MacBeth's concerns and raise these with Goldman/Caper? What difference would this make....can Goldman/Caper really change the issues that MacBeth has raised...and is McFeeley unnecessarily exposing himself?

4. MacBeth isn't done yet...he tells McFeeley that given (i) the uncertain commitment of the Company's current investors, (ii) the threat of a lawsuit from the ex-founders, and (iii) the proliferation of viable competitors in the industry, the most attractive story to investors will be a "flip"....essentially a commitment to sell the Company after 12 months. With a flip, the Company will only have to raise $2-3m, not the $5m required for an expansion round. These funds could likely be raised from current investors. However, the Company's acquisition value would be low...leaving no proceeds for holders of Common Stock after payment to the Peferred of their liquidity preference. Should McFeeley listen to this advice? How does he balance the lower risk to the Company by pursuing a flip...against the Company's good market positioning and potential appreciation and return to the Common if the Company does an expansion round and is successful? Should McFeeley make this decision by himself? Should he present MacBeth's advice to the Board and ask the Board for its


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guidance? If McFeeley decides to go to the Board…should he ask for advice or champion a position before canvassing the directors?

***Act Four – The Thick Plottens…..***

Whineblad Bummer determines that it needs the entire existing investor base to recommit to the Company in the next round. However, rather than reallocate the employee pool as proposed by GRV….Whineblad proposes that all of the shares held by McFeeley revest based on performance objectives. This proposal is crafted to address the fiduciary issues raised by the ex-founders by putting McFeeley's equity position at risk (which is the principle "fairness" argument raised by the ex-founders). Whineblad coordinates its proposal with McFeeley, and they privately agree (i) to set the performance objectives so they will probably be achieved, and (ii) as the achievement of the objectives will be approved by the Board, to stack the Board with "friendly" members so that approval is likely. Is the revesting of McFeeley's shares sufficient to address any real fiduciary issues on the allocation of employee shares? Should Whineblad coordinate its proposal with McFeeley in advance….or simply inform McFeeley that this is what the investors want to do? Is it ethical or pragmatic to handle the McFeeley revest issue as Whineblad has?

***Act Five – Sophie's Choice and the Fabster Phenomena…***

The MRS platform includes software that allows Money Professionals to capture and display on their individual webpages financial data, stories and stock quotes obtained from other sources – and from past surveys, the Company has determined that this platform feature is a critical market distinction for customers. The Bloomberg News Service determines that many MPs are using the MRS platform to illegally capture and display Bloomberg news feeds – and to stop this practice, Bloomberg sends a letter to the Company and to each of the investors threatening a lawsuit if the Company refuses to remove this feature. Anne Whineblad is particularly sensitive to this issue. Just last week her fund, and her partners John Bummer and Hank Scary were all sued by the Record Industry Association of America for the investment that Whineblad Bummer made in Fabster – a peer-to-peer file sharing technology platform. Based on court rulings in the Fabster case, Gordy Fameison has advises the Board that the Bloomberg threat can be addressed if the Company changes its platform so that MP websites (and the data on these websites) are hosted by individual MPs …and not by the Company. If implemented, this change will adversely impact the Company's current business model…which has already been shown to be effective. The development costs of making the change and the impact on revenues is unknown.

1 How should the Company respond to the Bloomberg threat? How should the individual investors react? Should the Company make the technology platform change, take the risk of a lawsuit, or attempt to license content from Bloomberg? Should the Company inform its customers about this?


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If so, when should the disclosure be made and what should the Company say?

2. The Company decides to change its technology platform to address the legal risk that Fameison has identified, but Bloomberg believes that the Company and its investor are still supporting and enabling illegal copying by MPs even if the Bloomberg content is not hosted on the MRS platform. Fameison is itching for a fight, he would certainly like the legal fees for his firm, and he encourages the Board and investors to stand firm against Bloomberg. Bloomberg wants the Company to disable the data capture and feed function – but again, market surveys show this would make the Company's business unviable. What should the Board and investors do now?

3. Whineblad Bummer has already invested $45m of the total of $60m raised by the Company to date, and Anne Whineblad believes that with the new financing completed and the positive trends in the industry, there is a likelihood of the Company being purchased in the next 18 months for $150m or more. Her LPs are skittish over the Fabster suit, however, and Whineblad's husband is concerned about the Whineblad Family's personal exposure. What about this? If the other directors want to confront Bloomberg, but Whineblad doesn't...and if her refusal to approve and participate in the financing will crater the Company, what's her exposure and what should she do?

## *Act Six – The Financing Gets a Bad Review....*

The terms for the next round provide that the Company will sell a new Series A-1 Preferred Stock raising an aggregate of $6m in 3 traunches of $2m each. All preferred shareholders will be allocated Series A-1 shares proportionate to their total dollar investment in the Company. Each share of Series A, B, and C stock will convert into a single share of the new Series A-1 stock or a single share of Common Stock based on the percentage of the allocation invested by that investor.....so that if, for example, an investor invests 30% of its total allocation in the financing, then 30% of the shares of Series A, B or C Preferred held by that investor will convert into shares of A-1 stock, share-for-share, and 70% will convert into shares of Common Stock. Charles Schnob holds 51% of the Series C Preferred Stock, and under the Company's existing charter documents the Series C has a separate approval right of the A-1 financing. Based on problems at Schnob Financial, Schnob decides not to invest. He first resigns his Board seat, then he informs the Company that he will not invest and he will not approve the A-1 round unless the non-participating investors keep at least 25% of their existing Preferred shares (ie. at least 25% of the shares don't convert to Common regardless of the amount of investment made in the A-1 round).


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Can the financing be structured around Schnob's refusal to provide approval? What about restructuring the financing as a secured note offering – or secured convertible note? What about amending the Articles to take away the separate Series C veto right (if that can be done...)? If any of these approaches can technically be done, is there any reason not to do this? As a blocking shareholder, does Schnob have an obligation to act reasonably....and not endanger the completion of the financing and investment made by other shareholders? Should the Board threaten Schnob or work out an arrangement with him?

2. The issues with the former founders and with Schnob Financial take 3 ½ months to work out before the Board finally approves the terms of the new A-1 round. Given this delay, the Company will run out of funds in 2 weeks. Gordy Fameison of Henpecked & West informs the Board that it will take 4 weeks to complete the financing, consisting of a 1st mailing to the Preferred shareholders to solicit interest, a 2nd mailing to prospective investors with a detailed Information Statement and other disclosures on the Company and the financing, and a 3rd mailing of subscription documents to those who wish to invest. To complete the financing properly Fameison suggests that the investors loan funds to the Company under notes converted into the A-1 shares when the financing closes. Furtiveson doesn't like this idea and insists on a faster process for an equity investment...as most investors are in the Company already...and the offering is being made only to accredited investors. What should the Board do? Can the Company take loans from some investors and not others?

3 All of the investors are concerned about their own liability, so they engage their own counsel. In addition, McFeeley hires his own lawyer to represent him in the negotiation of his revesting share arrangement. With over 5 lawyers involved in the transaction, is there any way for the Company to streamline this process? Can the Company refuse to deal with each lawyer individually and insist on a single lawyer to represent all investors (and other lawyers to work through him...)?

4 Assume that the claims of the ex-founders have not yet been settled. McFeeley's lawyer is concerned that, given the animosity that the ex-founders have towards his client, it may be better if McFeeley forfeits some of his shares (as this is what the ex-founders are contesting) for a cash bonus award that will be paid solely to him in the event of the acquisition of the Company. Will this solve the problem with the ex-founders? Is it fair to the other continuing employees? How should McFeeley sell this to the Board if he decides to go forward with this idea?


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## *Act Seven – Goldman Rats Wants to Reset the Stage....*

Prior to the close of the 1st traunche, the Board approved the distribution to all investors of sales projections for the current quarter based substantially on revenues expected from a partnering agreement the Company was then discussing with PriceWaterhouseCoopers. The projections assumed that PwC would resell certain of its own financial service products on the Money-Express website. 2 weeks before the closing of the 1st traunche, but after distribution of these projections, PwC notified the Company that PwC would resell its services through HotTicket...the Company's primary online competitor. No Board meeting was scheduled during this 2-week period before the closing, individual directors were not notified, and no one from the Company notified Goldman Rats Ventures of this development. In the 1st Board meeting after the closing, management presents new scaled down projections resulting in part from lost revenues from the PwC fiasco...and in part from a general downturn in the market affecting all competitors.

Vinod Khoslove of Goldman Rats Ventures is horrified by the new numbers. He feels that he and GRV have been materially mislead by management and by the Board. Who is responsible here? What should Khoslove do...and what are his options? Should he threaten management or the Board...and who is responsible? Is anyone responsible, or is the changed business climate the culprit? As GRV is an LP in Caper Kisser Furtiveson, should Khoslove be concerned about accusing the Board of a material omission (Furtiveson is on the Board)? What, if anything, should Khoslove be concerned about if he attempts to rescind GRV's purchase of the A-1 shares?

2. P.T. Barnum, the VP of Sales who replaced Feibel , told McFeeley about the lost PwC business AFTER the closing of the 1st traunche. The Board is upset over the situation, and to appease Khoslove, it determines it has to take action. Should it terminate Barnum? What if he is a star salesman and the key to future revenues? What about McFeeley...is he responsible? Should any kind of management reporting system be put into place to address this oversight moving forward? What should it look like?

3. GRV and the other inside investors agree among themselves to adjust the valuation of the Company by issuing 5-year warrants to the A-1 investors for the purchase of additional A-1 shares. Is this private agreement the right way to resolve the matter? Is this settlement fair to the non-participating investors? Should management, Fameison and disinterested directors object to this solution?

## *Act Eight – Money Road-Kill....or Reincarnation?*

After the 1st traunche, Bloomberg files suit against the Company and the individual directors. By this time, most of the investors in the 1st traunche have had enough bad


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news...and don't want to invest in the 2nd traunche. Furtiveson feels differently about the situation, and wants to continue to support the Company.

1 Furtiveson asks Fameison for his views on a secured bridge loan by RKF to continue Company operations. Should Fameison have this conversation with Furtiveson? Is Furtiveson now adverse to the other shareholders, or by extending the loan offer, is he acting in the interests of the shareholders? Is Furtiveson putting himself in harms way by taking a security interest in the Company's assets at this late point...or is he being fair to the Company? Who on the Board can approve this deal? Is it best if the Board passes on this...and pushes the deal to the shareholders for their approval?

2. The ex-founders, who still haven't settled with the Company, get wind of the RKF bridge proposal...and they are suspicious. As minority shareholders in the Company, they demand from management and the Board a list of other investors the Company has contacted to raise funds, detailed financials on how funds were spent, and confidential operational reports provided to the Board on sales prospects, market trends and financial projections. Should management and/or the Board provide this information? Is it wise for RKF to proceed with the loan if this is being openly questioned by the ex-founders? If RKF wants to proceed, should the loan be restructured? How can RKF placate the ex-founders.....or protect itself in moving forward?

3. RKF decides to move forward with the secured loan, and GRV decides to participate. Ultimately, no one sues when the loan is made, the bridge funds are not enough to sustain the Company...and all operations cease. The Board resigns, and all employees and officers quit. What should RFK and GRV do now? As secured creditors, do they have a duty to other creditors or the shareholders? Should they exercise on their security interest by credit bidding the loan amount under a UCC sale? If the total bridge amount was $1m, of which RKF put up $750k and GRV put up $250k...what do they do with the assets purchased in the sale? Prior to ceasing business, the Company subleased a portion of its offices to MeToo Corporation – and MeToo paid $250,000 to the Company as a security deposit. Can MeToo get its money back now after the UCC sale? What if the Company assets bought by RKF and GRV include the Company's cash account of $100,000 and $500,000 of Accounts Receivable? Does MeToo have a claim on this?


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