The New Reality for Information Technology Businesses

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There are a new set of legal and business requirements and constraints for information technology businesses in this decade. This article highlights the most significant forecasted changes and the impact on growing a technology business. The themes for the beginning of this decade include:

- Less venture capital available for early stage technology businesses.

- Abundance of capital for growth companies with recurring revenues and referenceable customers.

- Continued outsourcing of technology development on a selective basis.

- Restructuring of compensation plans for executives to address lower valuations and to increase employee motivation.

- Slowly improving initial public offering (IPO) market.

- Continually increasing sales activity to the federal government as a purchaser of technology.

- Steady increase in mergers and acquisitions, especially as large companies become more active acquirers.

- Greater focus on purchase price allocation and distribution of proceeds on a company sale and protection of shareholder rights.

With these expected patterns in mind, this article analyzes these areas and provides practical pointers for growing a technology company in the new decade.

1. Angel Financing and Early Stage Capital

A. Current Status:

Angel capital and early stage financing is more difficult to obtain now than in the past 20 years. With the downturn of the economy, many early stage investors have lost available capital to invest in start-up ventures. Also, many angels are fully invested in *illiquid* investments -- early stage companies that have not grown to the point of being able to go public or be sold. Consequently, angels and early stage investors will have to await the re-opening of the IPO and acquisition markets to achieve additional liquidity, allowing them to make new investments.

B. Forecast:

There is a bright spot on the horizon for early stage technology companies seeking angel capital. The optimism is based on the number of new IPOs expected in the beginning of this decade. With additional public offerings, angel investors should be able to harvest new capital to re-invest in existing early stage companies and in new start up ventures. Similarly, expect an upturn in mergers and acquisitions, especially in the second half of 2010. The result will be angel investors with greater liquidity and an increased appetite for investing.

C. Practical Pointers:

For early stage technology companies, the practical advice is to grow the business at a pace that is consistent with current cash availability. Angel money will be difficult to obtain for several quarters and existing angel investors may have difficulty re-investing in future financing rounds. Early stage tech companies should strive to achieve growth capital status -- the point in time where they are generating recurring revenues and cash flow positive.

2. Growth Capital and Venture Investment

A. Current Status:

2010 should be an excellent year for growth capital companies -- technology businesses that have established a customer base, a steady stream of revenue, and profitability. The real question becomes, why would these companies even consider raising capital in this market, especially at low valuations being offered by the venture community? For many growth companies, outside financing is necessary to accelerate product development, make strategic acquisitions, and improve customer service.

B. 2010 Forecast:

Venture capital will be flowing this year and early in this decade in the direction of growth technology companies. For the past 18 months, valuations have been depressed. Expect that valuations will increase in the beginning of the decade as the economy improves and growth technology companies expand their customer base. As a result, growing technology businesses will be able to attract more prospective investor interest. The resulting competition among venture investors will drive up valuations and increase the likelihood of closing more financings.

C. Practical Pointers:

Growth companies should carefully analyze their capital structure to understand the impact of new financing on existing shareholders, option holders and equity owners. Despite the expected upturn in valuations, the general terms and conditions of venture financing may be harsh. Consequently, managers and directors should understand the complexities of their capital structure and beware of terms such as:

- Pay to Play Provisions - requiring investors to re-invest in later rounds or risks the loss of preferential rights.

- Accruing Dividends - dividends that accrue at high rates of return and cumulate as a preference over other investors in a subsequent sale.

- Participating Preferred Rights - rights that allow a preferred investor to obtain a preferential return and then participate again on an as-converted basis along with the common stockholders.

- Additional Fees - other fees that may be imposed by the investor such as consulting or advisory charges.

The beginning of the decade should prove to be a record time for growing technology companies and raising outside capital at favorable valuations.

3. **Venture Capital Funds -- Competition and Challenges**

A. Current Status:

Venture capital funds currently fall into two categories -- funds with significant capital and those with a dearth of available funds. In the first category are venture funds that may have recently raised a new round of capital and are flush with available funds to invest in growing technology companies. Many of these venture funds are actively pursuing growth technology companies and seeking to deploy $5 to $20 million per portfolio company in multiple rounds of financing.

On the other hand are smaller venture funds, many of them regional, with limited available capital. These smaller funds must also allocate capital to existing, illiquid investments that may require new funding before an IPO or future sale. Several smaller funds are now assessing their ability to raise future funding and may be forced to wind down their current fund with no future prospects for a follow-on fund.

B. 2010 Forecast:

The venture capital playing field is undergoing a significant change. The larger funds will be investing in growth technology companies and experiencing greater liquidity as these companies go public or are sold.

For the smaller funds, many will be forced to reserve precious capital for existing investments, thereby being unable to invest significant amounts in growing or later stage technology companies.

In summary, the larger funds will grow and selectively make larger investments, and the smaller funds will contract with only limited ability to invest in a selectively smaller number of companies.

C. Practical Pointers:

For technology companies, the selection of a venture capitalist is crucial to the future growth of the business. There are several key questions that should be asked by the tech company and its advisors before selecting a venture fund:

- Does the venture fund have sufficient capital to fund the existing and future rounds of financing for the company?

- Does the venture fund allow for investments across its funds (that is, can the venture capitalist use money in later rounds of funding to invest in a company funded in the current round)?

- What is the track record of the venture fund's successful exits -- how many of its portfolio companies have successfully had an IPO or been sold at significantly higher valuations than the venture financing rounds?

- Are the principals in the fund still actively involved with their portfolio companies or have they retired, leaving the less experienced team members to manage the portfolio?

The trends in 2010 and early in this decade will result in significant changes in venture capital --

- Fewer but larger venture funds with more capital to invest.

- Struggling regional venture funds making fewer investments and with a questionable future in raising new funding.

- Even fewer venture funds focused on early stage technology companies.

4. **Mergers and Acquisitions - Deal Update**

A. The number of mergers and acquisitions has increased in the past year. The driving forces are many --

- Companies with cash find smaller competitors to be attractive at current, lower valuations.

- Struggling technology and business services companies prefer to be sold, even at a rock bottom price, rather than liquidating.

- Venture funds are encouraging portfolio companies to sell at the first sign of interest from an acquirer to achieve liquidity for the fund and other stockholders.

- Cash rich technology companies hope to expand product offerings through the purchase of new technology from third parties rather than internally developing it.

B. 2010 Forecast:

We expect more mergers and acquisitions activity in the beginning of this decade, especially as the economy improves. Selling a company will continue to be the preferred path to liquidity for venture investors and tired stockholders.

Although the IPO market will continue to improve, it will still languish in comparison with the 1990s. Specifically, the threshold for a company attracting the interest of investment bankers has been heightened, generally requiring at least $50-$100 million in recurring and predictable revenues and a high degree of certainty of continuing growth. These factors will continue to influence investment bankers, boards of directors and long-time investors to select a company’s sale as the preferred liquidity path. Additionally, an all cash sale provides all stockholders with instant liquidity and reduced risks.

C. Practical Pointers:

The increased mergers and acquisitions activity highlights the importance of several practical pointers for technology companies and their management, boards and advisors:

- Waterfall Analysis - conduct a review of the capital and equity table to determine exactly how the purchase price in a company sale will be distributed to stockholders, especially based on preferences, dividends, and compensation plans that may have priorities over common stockholders.

- Change of Control - review and analyze change of control provisions in employment agreements, option plans, restricted stock grants, and other agreements to understand the triggering events on a company’s sale, the acceleration of vesting, and the resulting impact on purchase price allocation.

- Investor Confirmation - Confirm the waterfall analysis and change of control vesting arrangements with the board of directors and lead outside investors to verify their accuracy and to address any irregularities with regard to distribution of purchase price on a sales transaction.

5. **Executive Compensation and Long-Term Planning**

A. Current Status:

Growing technology companies are re-examining their executive compensation plans to confirm alignment of company goals with executive incentives. The compensation committees of boards are reviewing the management's base salaries, cash compensation and equity grants to determine necessary adjustments. In particular, adjustments may be necessary as a company considers a possible sale in this decade, and management assesses the portion of the sales proceeds that may be distributed to officers of the company. Compensation consultants are also being retained by boards and compensation committees to suggest re-alignment of company objectives and executive compensation.

B. 2010 Forecast:

This will be a year of re-vamping of compensation and bonus plans as well as adoption of long-term incentive plans designed to encourage management to achieve the highest valuation on a company's sale.

This will be the decade for compensation committee members to retain outside consultants, review alternative compensation proposals, and determine the best set of incentives for management consistent with company goals.

C. Practical Pointers:

For technology companies and their advisors, the practical advice in the area of executive compensation will require a clear understanding of company goals for the year and alignment with executive compensation programs. The key considerations for outside advisors will include:

- Change of Control Payments - Boards and their compensation committees must understand the exact payments to be made to executives on a company's sale triggering a change of control provision, including the vesting of options and stock and payment of bonuses.

- Review of Existing Compensation Plans and Agreements - Existing employment agreements, severance arrangements, option agreements and plans, and restricted stock programs should be undertaken to confirm that there is conformity among these agreements and plans, especially on the events that trigger a change of control and accelerated vesting or early payments.

- Carve Out Plans - Boards and compensation committees may need to consider specially designed carve out plans providing compensation to executives ahead of other stockholders, especially where preferred stock rights and preferences may result in management (as common stockholders) receiving no value on a transaction.

- Retaining Compensation Consultants - Given the economic downturn and the complexity of compensation planning, boards and compensation committees should consider retaining outside consultants to make recommendations as to alternative methods for incentivizing executives to achieve the desired company results, especially if the goal is to sell a company at or above a pre-determined value.

6. **New Technology Requiring Legal Developments**

A. Current Status:

There are several new technologies that require application of existing and new legal principles to resolve legal disputes. In some cases, this means the development of new rules of law, and in others, it may require the unique application of existing legal doctrine to new technologies. The new technologies include:

- Cloud Computing
- Peer to Peer Computing
- Search technologies and Search Engine Optimization (SEO)
- Data capture, especially personally identifiable information
- User interfaces, including speech recognition
- Voice over Internet Protocol (VoIP)
- Social media and social networking, especially Facebook, Twitter, My Space, and LinkedIn
- Virtual Worlds, including Second Life
- Gaming and Entertainment

B. 2010 Forecast –

We expect this decade to result in a renaissance of legal developments being applied to new technologies. There are several reasons for the anticipated growth of legal activity in the technology area:

- New technologies are being adopted by companies at a fast pace even before legal standards of care have been created.

- Recent college and business school graduates are using new technologies and applying them to existing business problems, often bypassing the traditional policies and procedures adopted by larger companies.

- A large number of unemployed attorneys are aligned with charities and non-profit organizations, many of whom are active users of new technologies and are addressing evolving legal principles.

- The laws of other countries are evolving at different levels and are prompting U.S. policymakers to conform laws to uniform standards.

- Personally identifiable information continues to be improperly disclosed with resulting litigation.

C. Legal Causes of Action:

In the next few years, legal challenges to these technological advances will result in increased legal activity and causes of action in several areas:

- Antitrust - consider the Google project to scan and search every book every written.

- Patent - ongoing disputes as to the scope of patent protection, especially given the *Bilski* decision and the variability of patent laws in other countries.

- Copyright - continuing issues regarding the scope of copyright protection, especially with regard to new user interfaces, virtual worlds, and social networking.

- Privacy - efforts will need to be undertaken to conform privacy laws on the state, federal and international levels to provide consistency, especially given the universal nature of the internet

- Security - expect increasing expansion of criminal laws relating to security breaches, unauthorized access to computer systems, and impersonations on the web, both on the state, federal and international levels.