Founders’ Representations and Warranties in the Venture Capital Transaction

By:Jonathan D. Gworek
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In early rounds of venture financings, venture capitalists often seek representations and warranties from the company founders personally. These are in addition to representations typically requested directly from the company. This request for founder representations can lead to protracted discussions about what level of personal liability risk, if any, founders should be asked to assume in connection with the funding of a company they started. The purpose of this article is to explore this question in detail, and to offer a framework for approaching and resolving the related issues if and when they arise.

Representations and Warranties Generally

A quick primer on the nature and purpose of representations and warranties in the context of a venture capital transaction will be helpful in framing the discussion that follows.

Purpose of Disclosure. Representations and warranties are a series of statements that the venture capitalist requires the company to make in the securities purchase agreement. Through these statements, the venture capitalist obtains a clearer picture of the condition and operations of the company in which it is investing in order to make a more informed investment decision. Representations and warranties cover a broad range of topics, from very technical matters, such as the legal authority of the company to enter into the transaction, to much more operationally specific matters, such as the accuracy of financial statements and the existence of pending litigation.

The process of developing the representations and warranties can prove extremely valuable in the investor’s diligence process. A simple example illustrates this point. Virtually every set of venture capital documents will contain a representation and warranty intending to ferret out information about any outstanding legal claims, or facts that might be the basis for a claim, against the company. Typical language would read as follows: “There is no pending or threatened litigation against the Company, nor is the Company aware of any facts that might give rise to any litigation.” Of course, if this statement is not true — if there is litigation pending — the company may not give this statement without qualification. Any qualifications to the representations and warranties are listed in disclosure schedules that become in integral part of the closing documentation. It is in large part through this very exacting process, and the information that comes to light through the disclosure schedule process, that a clear picture of the company comes into focus.

Purpose of Risk Allocation. There are certain types of representations and warranties that both parties may understand are difficult for the company to give with a high degree of confidence. Nonetheless, the investor may still insist that these representations be given for purposes of risk allocation. By requiring the company to make such representations and warranties, the investor attempts to shift certain risks to the company. In the event the statement turns out to be false, the investor will have recourse for breach of contract against the company. The specific representations and warranties that fall into this category tend to be fairly predictable. For example, the investor will likely require an intellectual property representation and warranty to the effect that, in the operations of its business, the company does not infringe the intellectual property rights of any third party. This representation can be difficult for a company to give unequivocally in certain cases, especially as it relates to patent infringement. Often times, startup companies with limited resources would not have performed a substantial prior art search, and would not know for certain whether there was existing prior art they might be unknowingly infringing. In addition, given that patent applications are not immediately made public when filed, there would be no way of discovering every pending application even were an exhaustive prior art search performed. For these and other reasons, companies may reasonably suggest to the investor that they are only able to give such a representation "to their knowledge". Nonetheless, the venture capitalist may not be prepared to proceed with the investment without an unqualified intellectual property representation and warranty. Their view is that their investment decision is based on the assumption that the intellectual property portfolio of the portfolio company is clean.[1]

Founders' Representations and Warranties

Founders are often asked to make representations and warranties to the investors directly. The most sweeping type of representation a founder would be asked to make is a statement that the company's representations and warranties, as made by the company, are true and correct. This is the so-called "back up" representation as the founder would stand behind or "back up" the full representations and warranties of the company and provide the investor with a breach of contract claim against the founder directly should any of the company representations or warranties turn out to be false. In addition, founders' representations and warranties will typically also include representations and warranties specific to the personal, factual circumstances of the founder. These representations are generally limited to a narrow set of personal facts that are considered material to the investment decision. For example, the founder may be asked to represent that he or she is not violating any prior employment agreement, has never declared bankruptcy, or has never been convicted of a crime.

The Two Perspectives

While this second type of founder representation is generally considered manageable, the back up representation can be particularly disconcerting to the founder, and for good reason. Many of the company's representations and warranties are either highly technical and devoid of clear meaning to the average founder (e.g., representations regarding the legal authorization of the transaction), pertain to aspects of the company's operations of which the founder has limited or no knowledge (e.g., for the technical founder, representations regarding financial statements), or are of a nature (e.g., the intellectual property representation described above) that the company simply can not give them with any high degree of certainty. The founder is very reluctant to put his or her personal assets at risk in order to appease the investor's requirement for such a representation. Many founders, especially first time founders, do not have significant personal assets, and the thought of putting those they do have at risk is very troubling. The notion of providing direct representations also flies in the face of the one aspect of corporate law with which most founders are familiar and in which they take significant comfort — the limited liability protections afforded by the "corporate shield" that founders generally enjoy as stockholders.

The investor, on the other hand, naturally takes comfort in knowing that the individual founders are willing and able to stand behind the statements of the company. They want the founders to closely review these statements, work hard with their advisors to understand them, and be willing to put themselves at personal risk as to their truth and accuracy. The logic continues that if any of the material facts or circumstances upon which the investors make their investment decision turn out to be false, then by definition the cost of this error should be the responsibility of the small group of founders who caused the company to make such false representations.[2] This being the case, asking the founders to bear some personal risk is reasonable.[3] Otherwise the investors' only recourse might be an undesirable one-a claim against the company in which they just invested.[4] Venture capitalists might further suggest that if the founders are not aware of any specific reason the representations are not true, then they should not have a problem giving the backup representations — what is there to hide?[5]

Moving the Discussion Forward

Once the parties better understand their respective positions and motivations, reasonable middle ground positions can be established that provide the investors with additional comfort from the founders without the founders taking on undue personal exposure. Venture capitalists need to appreciate that just because the founders are uncomfortable giving certain representations and warranties, that does not mean the founders are being evasive or otherwise uncertain about the integrity of the company's representations and warranties. For some of the reasons described above, representations and warranties can simply be difficult to give with a high degree of confidence. On the other hand, the founders need to appreciate that the investors take comfort in founders' representations and warranties, and that such a request, if narrowed to accomplish the investor's business objective, is perfectly reasonable in many cases. Such a request does not mean the investors are somehow intending to penalize the founders.

When met with resistance from the founders, investors should go back to fundamentals and consider why they want the particular founders' representation and warranties in the first place — to ensure full disclosure or to allocate risk. If it is the former, as is generally the case, the investors should realize that there is little to be gained in asking the founders for a full set of backup representations and warranties. The investors already have the representations and warranties from the company. In this case, the investor might serve the process well by picking selected representations and warranties of particular importance and asking the founders to back up those only. That way the request is more manageable to the founder as there is a much more limited set of facts on which the founder needs to focus his or her attention. In addition, the investor might allow the founder to qualify all of the backup representations to the founder's knowledge. This approach will focus the founders' attention on the language, but will also not leave the founder at risk in the event that one of the representations and warranties turns out to be false without his or her knowledge. In return, founders should generally be able to give representations about their own personal circumstances without too much concern. In most cases, no knowledge qualifier should be needed. An example of an exception to this general rule might be representations that relate to violations of prior agreements by a founder as such a representation may raise technical, legal questions that are beyond the reach of the layperson founder.

Proposed Framework

Based on the considerations discussed above, and recognizing and anticipating that venture capitalists and founders are likely have two very different orientations as it relates to founders' representations and warranties, the following are specific suggestions for getting past these discussions in the event of an impasse:

- It is reasonable for the investors to request, and the founders to give, representations about the founders' personal circumstances to the extent such information is relevant to the investment decision. While there might be exceptions, no knowledge qualifier would typically be needed in order to make these representations.
- Investors should consider why they are requiring representations and warranties, and if the purpose is to ensure full disclosure, the founders should be allowed to qualify most representations, other than those specific to their personal circumstances, as to their knowledge.
- Even with a knowledge qualifier, the investor might consider limiting the backup representations and warranties requested of the founder to a very limited set of

representations that are both material to the investor and of a nature that the founder would reasonably be expected to understand and be able to obtain a command of the facts sufficient to make the representations to his or her knowledge.

- In the event that there is an honest misrepresentation (in the absence of fraud), the liability of founders should be limited to the value of their stock, and the founders should be able to decide whether to discharge their indemnity obligation through the payment of cash or with stock.

For more information on or to discuss founder representation and warranties in specific detail, please contact **Jonathan D. Gworek**.

Footnotes.

1. While beyond the scope of this article, when anticipated, this and similar negotiation points can be pre-empted early in the discussion by setting expectations clearly with respect to certain key facts. For example, if prior to signing the term sheet, the company discloses the fact that its technology is in a field in which the patent landscape is littered or uncertain, and the investor acknowledges this point, this might suggest that the investor is expecting a knowledge qualified intellectual property representation from the company.

2. This is an extension of a common refrain from the investors, especially with the very early stage, fresh startup, that the identity of the company and the founders is really one and the same at such an early stage, and that making the requested founders' representations and warranties should not present a hardship for the founders given the very limited operating history of the company. It is worth noting that the further along a company is, the more difficult is it for the founders to have the knowledge necessary to give meaningful representations and warranties. In part for this reason, founders' representations and warranties are rarely requested or agreed to beyond the Series A transaction.

3. One could argue that if the facts turn out to be other than as the investor thought they were, the cost of the misrepresentation, to the extend it should be borne by the pre-existing stockholders, should be borne by all of the pre-existing stockholders, not just the founders. Presumably, had the investors had the benefit of an accurate set of representations and warranties and proceeded with the transaction nonetheless, they might have negotiated for a lesser pre-money valuation. This would have resulted in greater dilution for all existing stockholders, not just the founders, thereby spreading the "cost" across all the stockholders. In the absence of fraud by one of the founders, this would seem to be the correct result as the overall enterprise value was reduced.

4. While beyond the scope of this article, the investors and their counsel should take some comfort in knowing that under the federal securities laws, including Rule 10b-5, while not the same as a claim for breach of contract, the investors might have recourse directly against the founders for fraud. Founders should also be aware of this and strive to cause the company to disclose fully and accurately all material information to the investors.

5. Investors should not be overly concerned with founder fraud. At this stage in the process, the investors have most likely done significant diligence on the individuals and the company. They are investing in part in the character of the founders and should presume that the founders are proceeding in good faith. If the founders have engaged in fraud, the investors will likely have larger issues than holding the particular individual accountable. They will also likely have recourse directly against the founder under the securities laws, as discussed above at note 4.