BerkeleyLaw
UNIVERSITY OF CALIFORNIA

Berkeley Center for Law,
Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

UNICORN VALUATIONS AND THE SILICON VALLEY

By Alan Parker, LL.M Candidate 2016 | October 2nd, 2015

Unicorn valuations and the problems related thereto are in the spotlight in Silicon Valley. Basically, this term is used when referring to invested start-up companies with a pre-money valuation (*i.e.*, before a venture capital investment) equal to or greater than one billion dollars. This is in a context where, by nature, it is extremely hard to accurately determine the value of a start-up, as most of them do not have any operational background.

When a venture capital investor agrees to invest and acquire shares in a start-up with such a hefty valuation, it will most likely ask for several contractual guarantees aiming to ensure a minimum return on its investment, and that's when problems may arise between investors and the founding shareholders.

These contractual guarantees vary on a transaction-to-transaction basis, but in general venture capital funds will request to receive preferred voting stock with conversion rights, anti-dilution protections, redemption rights, liquidation preference rights, participating double dipping rights, among others.

All of these complex contractual arrangements, that can be better detailed in a further article, have one basic goal: ensure that the venture capital investor will receive at least the amount of the invested capital before the founding shareholders in case of a future liquidation event of the company, such as a sale or merger. In other words, entrepreneurs only get a reward, if any, after the investor receives the minimum invested capital.

It is clear that a venture investor would be more comfortable with a very high pre-money valuation when these contractual guarantees are implemented, as at least the invested capital should be recovered. In such circumstances the investor may even be pushy for an inflated valuation. However, as pointed out in an article recently published by Prof. Steven Solomon, there is a considerable risk that the venture investor and the founder will not have their interests aligned if the company is later sold or merged based on a lower valuation, whereby the founding shareholder could be faced with the possibility of not receiving any cash for that transaction. This is the main subject of discussion of the unicorn deals.

On the other hand, such contractual arrangements are designed to trigger only when a start-up fails to meet the expected "future valuation." In an ideal scenario, such rights are not enforced by the investor because the proceeds of a sale would be sufficient to distribute enough cash and profits to all selling shareholders. Therefore, although inherent with risks for the Silicon Valley entrepreneurs, these contractual guarantees may be deemed as important facilitators of venture capital funding for start-ups and, thus, for the economy in general, but entrepreneurs should be fully aware of its impacts before entering into a venture capital transaction.