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Memo:VENTURE CAPITAL SURVEY: A MERCURY NEWS SPECIAL REPORT

THE ALMIGHTY BOTTOM LINE

JUST LIKE IN PUBLIC DOMAIN, GREED REARS ITS HEAD IN VENTURE CAPITALISM AND LEAVES UGLY CONSEQUENCES

MATT MARSHALL, Mercury News

The e-mail popped up on Aamer Latif's screen early Aug. 1.

His company, **Nishan** Systems of San Jose, was accepting $5.5 million in loans from the venture capitalists on its board. The return they arranged for themselves? Effectively 800 percent.
The terms ensured that the venture capitalists got most of $90 million when the company was sold days later -- leaving most of **Nishan**'s hundred or so other employees out in the cold. And that was just the last of many behind-the-scenes maneuvers by the venture capitalists, according to a lawsuit Latif filed recently in Santa Clara County Superior Court.

''The reality is, there are no checks,'' Latif, a founder of **Nishan**, said of the VCs' power. ''They can get away with murder.''

The venture capitalists named in the suit, Lightspeed Ventures and ComVentures, did not respond to repeated requests for comment.

The world of private start-ups still falls largely outside of scrutiny byregulators, even as controversy rocks most of the rest of the investment arena. The public stock market has been plagued by scandals such as the excesses at Enron and the New York Stock Exchange, and the mutual fund industry recently has come under the spotlight.

However, here in Silicon Valley, it has become normal to shrug off the tales about greedy venture capitalists as, well, just part of doing business.

Venture capitalists say it is their job to maximize profits, and in risky times they have to play hardball even if it means setting tough terms. But the result is that after years of work, many employees at start-ups end up with nothing -- even as VCs sometimes make off with millions.

One way they make millions is through ''liquidation preferences,'' which put them in line to get their money back first when the company is sold. If there isn't money left for the common shareholders -- the regular workers -- so be it.

As the economy went sour, VCs inserted these preferences into deals with companies desperate for cash at any costs. In fact, a majority of liquidation preferences ensure VCs get two-fold or three-fold their money, before others get a dime, according to a study by Ernst & Young and VentureOne.

"The gold makes the rules," said Barr Dolan, a partner at Charter Venture Capital in Palo Alto, who has no connection with the **Nishan** case. The company founders "hate that. . . . There's vast situations where company founders get screwed. That's just the way the world goes."

Harsh terms

Now that the economy is recovering, big companies are more likely to acquire start-ups, unleashing some of the ugly terms. Many workers are getting a nasty surprise because often little was disclosed to them about the VC preferences.

While the terms may be harsh, they are for the most part legal, said Larry Kramer, a lawyer with Palo Alto's Fenwick & West, who has followed the trend. But in the case of **Nishan**, VCs acted deceptively against the company's interest in how they got the terms approved and the company sold, according to the lawsuit.

The whole experience turned sour because the venture capitalists themselves came under pressure to recoup the money they had lost on other investments, said former employee Randy Fardal.

"Their personalities changed in the panic," he said. "It's like in Las Vegas, at 2 a.m. you hear them muttering, I've got to get back this money before my wife finds out."

Here's the story according to interviews with half a dozen employees and court documents filed by Latif, who was chief executive of **Nishan** until he departed in 2002 because of differences.

The drama unfolded over the course of a year. In 2002, two venture capitalists on **Nishan**'s board, Roland Van der Meer of ComVentures and Gill Cogan of Lightspeed, began stacking the board with allies so they could push through their interests, according to the lawsuit.

That included hiring John McGraw as interim CEO without disclosing to the board that McGraw was a venture partner at Lightspeed. The venture capitalists also hired CEO Robert Russo in November last year without the board's approval.

McData's interest

In January, **Nishan**'s sales were growing and Russo said the storage networking company would go public next year. Soon though, the company ran tight on cash and began looking to raise money or find a suitor.

By April, executives at Colorado-based McData were spending increasing amounts of time at **Nishan**'s offices. Many **Nishan** employees believed McData wanted to acquire the company.

But in June, Van der Meer and Cogan, who between them owned about 25 percent of the company, proposed a financing round and, according to Latif, sought to keep it "inside the family" -- limited to a hand-picked group.

They wrote in a three-fold liquidation preference, which promised to guarantee them a stellar return in the event of a sale -- to McData, for example. However, a majority of **Nishan**'s common shareholders rejected it.

Then, on June 17, Russo, in concert with the venture capitalists, retainedCredit Suisse First Boston to help search for a buyer -- without the full board's prior approval, according to Latif.

Nishan paid $2.5 million to the investment bank for its services. It is not clear why CSFB -- which is also named in the suit -- was paid so much, considering McData was already interested. A CSFB spokeswoman said only that the suit is without merit and that CSFB will fight it.

On July 17, McData made an $80 million offer for **Nishan** and carved out $5 million of that for common shareholders. However, **Nishan**'s management negotiated to boost the offer price to $90 million and drop the amount for common shareholders to $4 million. **Nishan** management also deleted a requirement for a "fairness opinion" to be delivered to **Nishan**'s board, asserting that the merger was fair to all shareholder classes.

McData accepted the changes, and on July 29, **Nishan** approved the terms.

CSFB's Jason Greenberg told the board the deal was so secure that **Nishan** would have grounds to sue if McData pulled out. That's when the VCs crossed the line, according to the lawsuit.

Two days later, Van der Meer and Cogan proposed $2.5 million in "bridge loans" to tide the company over until the sale went through -- which they now knew was practically a sure thing. They put in the liquidation preference to get their money back three-fold. At the same time, they put a similar preference retroactively into a $3 million bridge loan approved earlier.

Voting for sale

The venture capitalists now needed to make the sale happen -- which meant getting a majority of common shareholders to approve it. So in mid-August, Russo offered a select group of management -- those with a lot of stock options -- special retention bonuses. They also asked those employees to sign a proxy permitting the company to vote their shares in favor of the sale to McData.

The venture capitalists and McData also arranged to pay Russo $1.1 million -- far more than the $100,000 severance package in his contract. They pressed him to accelerate his exercise of 4.1 million options so he would have more shares in the vote.

Also, until then, they had not disclosed a sexual harassment claim against Russo made months before. The lawsuit contends that the claim was not disclosed to protect Russo because he had so many shares. Russo declined to comment.

Now they needed to work on other shareholders. Forty-two of fewer than 50 employees in the engineering department signed a letter to McData saying they were unhappy.

Meanwhile, Russo called in the hardware team, told them he had heard griping, and said it was important for them to vote for the sale. He sent the VP of engineering, Bill Fuller, to knock on doors, pressuring employees to sign.

"That put me under tremendous pressure," said one of the software employees, requesting anonymity.

It worked. The sale passed by a 55 percent vote. Russo's shares amounted to 14.7 percent of the common shares -- which helped the sale get through.

The venture capitalists and the select group of management raked in a three-fold return on their loans -- $16 million of the $90 million McData paid. And they got it so fast that their effective annual return was 800 percent. They also got most of the $59 million reserved for "preferred shareholders."

Russo left the company with $1.5 million just days after the merger was signed in September. McGraw, who served as interim CEO for six months, also walked with $1.1 million and his shares.

Most employees ended up with less than $50,000 from the sale, after working with **Nishan** for three or four years.

"The experience has left such a bad taste in my mouth, I'm not even interested in trying again," said another early employee, requesting anonymity.

Latif ended up with about $880,000, still a lot more than most employees but a lot less than the venture capitalists. Besides the lawsuit, he's writing to regulators like the Securities and Exchange Commission and the California Commissioner of Corporations, requesting that they investigate.

Latif said such deals are dissuading him and thousands of other entrepreneurs from ever taking venture capital money again, a sentiment echoedby several other **Nishan** employees.

"It's not worth it," he said. "It's disturbing to see this many wrongs being done."
VC POISED FOR PICKUP
Venture capitalists stayed steady with their investments into Bay Area companies during the third quarter, though signs suggest the pace will pick up.

Some observers say a stronger stock market and more public offerings will encourage venture capitalists to open their wallets in the near future.

In the Bay Area, venture capitalists invested $1.38 billion during the quarter, according to the MoneyTree Survey, conducted by PricewaterhouseCoopers, Venture Economics and the National Venture Capital Association. That's a 7.4 percent drop from the $1.49 billion invested during the second quarter.

The decline is small enough to be considered within the margin of error. Statistics are often revised as quieter deals are reported.

Nationally, venture capitalists invested $4.2 billion, or 8.7 percent less than the $4.6 billion during the second quarter. Despite the slight declines, both national and local investing remain at higher levels than the first quarter -- which appeared to mark the bottom of the investing cycle.

One positive spot was biotechnology, which attracted more money than any other sector. Traditionally, software has claimed the title as top dog.

Illustration: Photo, Charts (3)

PHOTO: RICHARD KOCI HERNANDEZ -- MERCURY NEWS
Nishan founder Aamer Latif says behind-the-scenes maneuvers by the venture capitalists left most of the company's hundred or so other employees out in the cold.

CHART: WES KILLINGBECK -- MERCURY NEWS
Funding little changed
[Chart not taken in database]
CHART: WES KILLINGBECK -- MERCURY NEWS
Where Bay Ared investments went
[Chart not taken in database]
CHART: WES KILLINGBECK -- MERCURY NEWS
Where national investments went
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