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A Capital Venture

Richmond wasn't like Charlottesville. C'Ville had no real aristocracy, no old-money upper crust. Newcomers were welcomed here. But in Richmond, being a fourth-generation blue blood still counted for something, even if the money, old as it was, had dwindled in generations past.

Kyle South's blood was blue enough. His family went back generations, and with that genealogy came status, and with that, connections. Being a graduate of the prestigious Darden School of Business at the University of Virginia didn't hurt, either. The old-boy network still thrived, even if the boys were not all that old.

He didn't comport himself as your average over-privileged rich kid. Kyle worked hard in his role as technology merchandiser. He was enthusiastic, organized, and systematic. He contacted vendors and was able to explain our concept as well as Bill Hunt, and that was saying something. But Kyle South couldn't seem to get to "Yes."

Craig, of course, was batting a very high average. He struck most people as the most persuasive fellow they had ever encountered. It was no surprise that Bill was generating a reasonable number of yeses, too. He was a pro with decades of experience and a lifetime of great contacts.

Rex Scatena, still living in California, was spending more and more of his time selling Value America and less of it practicing law. Even though he had never sold a thing in his life outside a courtroom, he had a remarkable rate of success, even better than Bill's. Rex had a ton of money invested in the venture, and we sometimes wondered whether his success was due to his ability or his motivation.

But Kyle wasn't making it happen. He seemed to be making all the right noises, but a disproportionately large percentage of his consumer technology brands had declined to participate. He knew only too well that his compensation was predicated on his performance, and that his contribution to the company's coffers was falling far short of what he was getting paid. Clearly, it was time to look for other ways to make himself valuable. It was time to tap the old-boy network.

To Kyle South, the obvious place to start was the law offices of Caise, Perkins, in Richmond. Justin Caise was an attorney specializing in solving the problems encountered by emerging businesses, including the biggest problem: raising money. This was invariably the Achilles heel of entrepreneurial enterprises like Value America.

The law firm of Caise, Perkins came highly recommended. The partners included one Jim Gilmore, soon to be Governor of Virginia. George Allen, the current Governor and future U.S. Senator, was a close personal friend. The list of high-rolling notables on a first-name basis with Justin Caise, in both politics and business, was impressive. And Justin knew Kyle South. How fortuitous.

Justin's appearance wasn't exactly what Craig had expected. It wasn't his face or build, which were pretty ordinary, but his hairstyle—swooped straight back and fixed into place. Justin's style sense was either way behind or way ahead. Craig prayed it was the former.

Hairstyle aside, Caise was a professional, and we had pressing issues. Re-incorporation in Virginia was high on Justin's list. He told Craig that takeover issues and board protections were superior to those in California or Nevada. But the "staggered" board structure Caise recommended would later prove to be less than ideal.

Craig had drafted stock agreements for the original employees that suggested grants. He told Justin that he wanted to make these legally binding. Justin's counsel was to use options instead, and he outlined good legal and tax reasons for doing so. Winn understood, but knew that it would take some time before the company could afford to pay the $15,000 in legal fees required to implement the plan. He had a choice between taking care of the stock program—which he needed to do sometime soon—or making payroll that week. He chose the latter.

Justin helped Rex out on some trademark issues and generally made himself useful as the company's new legal counsel. Yet his most significant role would be guiding us through the tricky and dangerous shoals of private investment funding.

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"I know they're small. So are we."

Kyle had a point. But the bigger issue was that the Madison Company had never raised funds for a technology firm. Yet we needed money. Kyle's friend at Madison, Lyle Timmon, a fellow Darden alumnus, said he could help.

We were trying to raise a million dollars on a valuation of ten million. One million, we thought, would be enough to get us over the hump. The problem was the valuation. Rex had tried it out on his friends, and Craig had done the same. The only reaction they were getting was polite amusement. Ten million dollars? This was an Internet store with about fifteen employees, hanging out in an Attic in Nowhere, Virginia. A helluva business plan, but ten mil? No, I don't think so.

Madison didn't see it that way, though comps were hard to come by. About the only comparable company was Amazon.com. They were just then in the process of going public, so their numbers were readily available. The interesting thing was that Amazon's pre-IPO worth, calculated for their private investment rounds, had been based not on profitability, but on forecasted revenue. As a private company, Amazon had been valued at sixty percent of projected future sales—sixty percent of the revenue they expected to generate in the upcoming year.

By that math, Value America was worth a whole lot more than anybody thought. Craig's revenue projection for 1998 was $40 million; sixty percent of that put the company's value at $24 million. Even rounded down to an even twenty, it doubled our valuation. Using this math, the prospects looked good for raising $2 million in working capital.

Pessimists do not start businesses. Entrepreneurs, who do, are optimists by nature. It is therefore common for their growth projections to be sinfully inflated. It bears mention here that such was not to be the case with Value America's unabashedly entrepreneurial top management. As far back as late 1996, Craig and Rex had predicted revenues of $40 million in '98 and $175 million in '99. Both numbers proved correct—on the conservative side. So much for starry-eyed optimism.

Raising venture capital begins with writing a description of the company and its business prospects. When preparing for a public offering, this document is known progressively as the "S1," the "Red Herring" (the pre-IPO version, characterized by the red text on the cover), and the post-IPO "Prospectus." In the world of private investments, it is simply known as "The Book." It begins with an executive summary, followed by an analysis of risk factors, a description of the company, and its financial projections, for which an independent audit must be performed.

The requisite audit was to be our company's first. Half a dozen large accounting firms were interviewed, but we chose a small local company, to save money and to expedite the process. They confirmed that while as an entrepreneurial company it was necessary to know where every dollar was at any given time, presumably because there were so few of them, there was another method of accounting with which the financial community was more comfortable. Thus began the discussion of cost versus accrual accounting.

When you're strapped for cash, as we were, the only thing that counts is how much of it you actually have. Thus, you'd use cost-based accounting, which told you, "This amount came in, and that amount went out, leaving you this much." It's accounting based upon one's present reality—not unlike a checkbook.

Accrual-based accounting is more Dickensian in nature. Its reality takes into account the Ghosts of Christmas Past, Present, and Yet-to-Come, which is a poetic way of stating that it allocates costs and profits over the entire period in which they should be properly recognized. This method is expected of companies engaged in raising or borrowing money. So every publicly traded firm, and those planning to go public, find themselves using this somewhat less straightforward form of arithmetic.

In practical terms, all of this meant we had an accounting issue with the money generated by our product presentations. Mind you, it was the only revenue we were earning. Technically, our fees just covered the labor it took to build them, including a substantial margin. But since we agreed to host them online for three years, that made their useful life three years for accounting purposes.

For bookkeeping, then, should the presentations be sold like cattle—cash on the barrelhead—or amortized over their useful life? If the commonly accepted valuation basis for companies like ours was shifting from "past profits" to "forward revenues," then shifting to accrual-based accounting was a no-brainer. It was the best of all possible worlds: we already had the cash, but it wasn't counted as "revenue" until next year or the year after that, making the company look all the more valuable on paper.

In due time, "The Book" was completed. The documentation was in order, and the "due diligence," the formal investigation of the company's financial soundness, had been given, well, due diligence. Madison was poised to introduce Value America to the local venture community. It wouldn't come a moment too soon.

As time went on, a remarkable pattern began to emerge: the Darden connection. It seemed that almost everywhere we went, there was someone in a position of influence who had graduated from UVA's Darden School of Business, often in the same class as Value America's merchandiser, Kyle South. Getting a foot in the door of the east coast investment community appeared to be quite a bit easier if the foot happened to be wearing Kyle South's size-ten Gucci loafer. How could one guy know so many of the right people?

Private investment rounds like this are precursors to public offerings. Investors aren't putting their money at risk just because they think the company's concept is sound. They're doing it because they've calculated that the odds are good the company will go public in the near term, so they can cash out. Venture capitalists are gamblers at heart, but gamblers who won't place a bet until they know how the deck has been stacked.

Craig and Rex got good at presenting our company to the venture capitalists. Practice makes perfect, and they got a lot of practice during the spring and summer of '97. It was basically the same presentation that they gave to the brands, but geared to an audience with a different agenda. The presentation never varied much, and invariably it had a positive impact.

A Richmond investor representing Jefferson Capital made the short trip from the state capital to meet with Craig and her friend, Darden classmate Kyle South. "Kyle, so good to see you again," the diminutive blond said as he greeted her in the lobby. "Nice little building." The Attic was in a charming white brick house with black shutters, just east of town. One could see Monticello peeking through the trees on a hill less than a mile away. Our hosts didn't even have a sign outside, but we did. Our two-foot- square, hand-painted rendition of the Value America logo made it look like we owned the joint, humble as it was.

"Our offices are upstairs," Kyle said, "but let me show you around."

They toured the server room in the basement, which looked impressive with its banks of humming glass-enclosed computers on a raised floor for cable management. In reality, it was overkill for Commonwealth and, for the moment, extreme overkill for us. But it sure looked good.

Once in the Attic, he introduced Jefferson to Craig, who until now had been a disembodied voice on the phone. After a quick tour of Presentation Marketing and Web Development, Craig and Kyle escorted her to the big conference room on the main level, where she and another potential investor, Smithers, were given the pitch.

After making several such trips, both venture capitalists said "Yes." Jefferson Capital's Darden grad asked to be our lead investor.

The search for capital went beyond Virginia. We traveled to New York to visit the prestigious investment firm of Wasserstein Perella. We wondered if the northern halls of power and wealth would respond as positively as had genteel southern money. Sure enough, they joined a rapidly growing chorus of venture capitalists who saw our potential.

We visited two firms in Washington D.C. The first was Allied Capital, who joined the others chanting "Yes." The Carlyle Group said "No." Carlyle, a successful and politically connected venture firm, made it clear, however, that their negative answer had nothing to do with Value America per se. They said the Internet was not a sector in which they were making investments. They had no one who could properly analyze the merits of an online retailer, or any Internet-related company for that matter. Several of their principals would later become individual investors in our star-studded "Series C" round. Their "no" really meant "not yet."

As Madison's Lyle Timmon witnessed the uniformly positive reaction of venture capitalists on the east coast, he offered to take Value America west, to California. The heavy hitters in the Silicon Valley were Kleiner Perkins and Softbank. Both had sterling reputations investing in Internet start-ups. They had backed all the right players.

But a bit of research revealed something disturbing about them. In Japanese business culture, it's called keiretsu, mutually beneficial corporate back scratching. If they invested in Yahoo, for example (which they did), and also in Amazon (which they had), they would be in a position to influence both companies, though they would surely characterize it as "suggestion." Amazon, for example, might be "encouraged" to buy an anchor position on Yahoo's portal—at, say, $5 million a year. At the same time, Yahoo might be "motivated" to give Amazon preferential treatment, like giving them exclusives. It was all geared to make both Amazon and Yahoo! look more valuable, thus increasing the value of the investors' holdings.

It was all perfectly legal, as long as they didn't go too far, but there was a dark side. It was rumored that if these 800-pound gorillas in the venture world decided your goals were no longer consistent with theirs, they had not only the power, but also the will, to shut your business down. The founders decided that we could do without another challenge and asked Lyle to politely unschedule us. There were plenty of willing, even eager, fish in our pond. And old money was just as green.

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"John," Craig said into his speakerphone, "your lawyers are about to do you in. I told you I'd take care of you."

Motley replied in their defense, "They're considered one of the best firms in Washington. They've never steered me wrong before."

"Listen, John, I like you and your family. I appreciate everything you've done for us, so I'm going to go over all of this again." Craig gave John chapter and verse on stock options, vesting, strike prices, and exercise periods. "If you're willing to trust me, I'll give you everything I've promised. If the market holds out, and if we're able to deliver on our corporate promises, you'll do just fine. But, I'm only going to do this if you tell your lawyers to back off and stop hounding me."

"Okay. I'll call them," John said with some trepidation.

"Good. Katie, the boys, and I are going to Wintergreen this weekend. Do you know where it is?" Craig asked.

"Sure."

"Meet us there. We'll work out the details." They did, and in time, just as Craig had predicted, John Motley became a rich man. No one deserved it more.

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To Johnny-Mot and Bits (i.e., John Motley Jr. and his little sister, Elizabeth), it was just school. But to their parents, it was something more. The Potomac prep school was one of the finest in Washington.

Rich Fairbank's kids also attended Potomac. John, the master of personal networking, had gotten to know the Chairman and CEO of CapitalOne, as he had many of the Potomac parents. Motley had become convinced that Value America was poised for greatness, so we were on his mind as he was greeted by his friend following a school function.

"Hello, John. Bits did a great job in the program—cute as a bug."

“She’s definitely got her mother’s talent,” John said proudly. After exchanging pleasantries, Motley brought the conversation around to business, as men are wont to do. “How’s the credit card business these days?”

“Just keeps getting better.” CapitalOne had made its mark by exploiting a niche market that others, not recognizing its potential, had avoided. They provided credit cards to people with less than perfect credit. Ordinarily, this could be a formula for disaster, but CapOne had done its homework. They had hired dozens of MBAs to do financial modeling. Together, they had invented ways to identify deadbeats while finding those, despite their questionable credit profiles, who were acceptable risks.

Rich Fairbank and his team had discovered an often overlooked truth—a truth as old as the Bible: there is no correlation between a person’s wealth and their propensity to pay their bills. The honoring of one’s debts is a matter of character, not of income. The tip-off for CapOne’s analysts turned out to be absurdly simple. No matter what else the applicants put on their forms, if they listed an accurate telephone number, they were likely to pay their bills; phony phone number, they’d try to stiff you. They may be a little over their limit, and they may pay a few days late, but they’d pay.

Credit card companies like CapOne depend on direct mail advertising to grow. But it’s an expensive hit-or-miss proposition when the solicitation is addressed to “Occupant,” or even to the more warm and sincere “Resident.” Any direct mail marketer will tell you that your mailing’s success rate will only be as good as the quality, accuracy, and appropriateness of your list. Paying to print and mail a catalog full of frilly lingerie to a fifty-two-year-old bachelor auto mechanic without a credit card is, entertainment value aside, a guaranteed waste of money.

But in a coordinated effort, credit card issuers and direct response retailers could form an incredibly profitable symbiosis. If you knew that your solicitations were going exclusively to people who had credit cards, and who had purchased the kind of things you were selling, then you had a recipe for success beyond your wildest expectations.

“Rich,” John said, “I recently met a guy whose company is poised to make some breakthroughs in Internet commerce. His name is Winn. The company is Value America. They’re doing some remarkable stuff.”

“E-commerce?” E-tail was the electronic incarnation of direct response. Rich was immediately interested. The attention the new field was getting on Wall Street and in the media was hard to miss.

“Yes, and you know, at some point they’re going to want their own credit card. Maybe you two should put your heads together.”

“That’s a good idea, John.” Rich pulled out his business card and scribbled a name on the back. “Why don’t you get him in touch with this gentleman. If he likes what he hears, we’ll go from there.”

Craig had a word for them, homo-chromos—short for homogenous chromosomes. All of these MBA types, it seemed, had been stamped out with the same cookie cutter: same age, same haircut, same suit, same advanced degrees from the same prestigious colleges, same high class standing, same lack of experience, and the same arrogant superiority toward lesser life forms—especially entrepreneurs. This one was no different. He was certainly bright enough, polite and business-like, but Craig got the distinct impression that he had gone to kindergarten wearing a suit and tie. Enthusiasm and passion were apparently signs of weakness.

Yet this fellow was responsible for business development at CapitalOne, so Craig, who indeed foresaw the need for a store credit card, was happy to give him a tour of Value America. The nameless, faceless MBA must have thought the concept held promise, because he immediately set up a meeting with his boss, Rich Fairbank.

The rendezvous took place at Fairbank's retreat on Gibson Island, a private enclave in the middle of the Chesapeake Bay, situated between the historic ports of Annapolis and Baltimore. Craig and John had brought the store-in-a-box, the big 3M projector, and a large screen. But it was a beautiful day. A deep cerulean sky was punctuated with puffy white clouds. The porch provided a perfect view of sailboats gliding along the Maryland coastline, so they decided to give the pitch outside on the patio.

Craig proposed a rather unusual alliance, uniting "the key and the door," as he saw it. The key to e-tail was the credit card. Without electronic money, there was no "e"-commerce. And Value America was the ultimate online doorway between consumers and brands.

Forming an alliance with CapOne presupposed that Value America would have been given the opportunity to serve their customers. That would give us several advantages. Everyone on their customer list, by definition, had a credit card, and let's face it, it's really hard to shop online without one.

Second, the list was accurate. It had to be, because it was comprised of the cardholders' billing addresses. You could spend years, and a whole lot of money, trying to compile such a perfect customer list.

Third, those on the list trusted its keeper. After all, CapOne was their bank. Endorsed by CapitalOne, Value America would gain instant legitimacy. Fourth, CapOne knew where their cardholders shopped and what they liked to buy.

Craig was also desirous of partnering with CapOne's call center, which used the best technology for routing and managing tens of thousands of phone calls a day. Unlike most Internet prognosticators, he firmly believed that the telephone would play a critical role in the implementation of any successful Web retail establishment.

Rich, after absorbing the presentation, came to the conclusion that their two companies could indeed be very good for each other, but the partnership need not stop there. He asked if CapitalOne could become the sole investor in our private funding round.

After a moment's reflection, Winn realized that we were too far down the road with the other investors to let one company have the whole deal. But there was no reason CapOne couldn't be a lead investor. In the final analysis, with their credit card, customer data, direct mail solicitations, and call-center capabilities to sweeten the pot, CapitalOne's money was greener than anyone else's.

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"We've got a problem, Rex," Craig said with a grin. "We've got more investors than we've got company to invest in."

"There's not enough stock to go around."

"Jefferson wants two million. Allied Capital thinks that anything less than a million isn't worth bothering with. Wasserstein Perella wants at least two million. Smithers wants in too. Now with CapOne wanting more than two million, plus an alliance that could blow the doors off e-commerce, we've got too much demand." Craig paused. "For a company two paydays away from being broke, we sure are popular."

"Maybe the round's valued too low. After all, it's been a few months since we started beating the bushes. We've made a lot of progress since then, especially in signing up brands. You saw the reaction at United Stationers—it was like a stampede! We're performing much better than we said we would. What if we raised the price?"

"It would tend to weed out those who aren't serious. As soon as somebody backs off, we'll know we've zeroed in on the right number. Our worth, apparently, is no longer a matter of arithmetic, it's a matter of perceptions—craziest thing I ever saw."

"So long as we don't slow down the process," Rex cautioned, "I say we raise the valuation. Thirty million has a nice ring to it."

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He sure didn't look like the typical CapitalOne "suit." He arrived in a van reminiscent of the hippy era. He wore his hair in a ponytail, and he didn't talk at all like a financial guru. But, like everyone else we had encountered at CapitalOne, he was definitely smart.

He was a techno-wizard, CapOne's CIO, and he had come to evaluate our systems. He knew, as we had discovered, that there was no off-the-shelf software available—at any price—that could do any of the marvelous things we claimed to be doing. Were we for real, or were we just a house of cards?

Joe and Lad spent hours with him. He wanted to know how we drove our site dynamically out of a database. How did our authoring tool empower artists and writers? How did we make our EDI solution work with everybody else's? How had we solved the problems of blind-launching audio and automatic pagination? He asked a plethora of intelligent questions.

Joe and Lad demonstrated how it all worked. They showed him thousands of lines of code. They opened his eyes. The CapOne techno-guru went back to Richmond armed with the knowledge that Value America had actually accomplished things no one else had even attempted. Should they invest? Hell, yes!

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Rex Scatena had finally moved to Charlottesville. His law practice was history, yet few of Value America's employees had any idea what Rex meant to the company. He had just shown up one day with the title of President. He was an executive, a merchandiser, and an ex-lawyer who had a lot of meetings with Craig, now managed the company's checkbook, and traveled to most every trade show. That's about all anybody, except for Joe Page, Bill Hunt, and me, knew about him. Craig was more relaxed now that Rex was here; that much was obvious, at least to me.

Our one-year anniversary had come and gone without anybody noticing. We were too busy just trying to survive. But enough time had passed for us to have developed some concept of our place—our value to the firm.

I tried to be scrupulous in treating my Marketing team members with respect, praising them when they'd earned it. I knew how far a little encouragement could go in a stressful situation, especially among creative types. Unfortunately, that didn't mean that I was in a position to give them raises, no matter how much they deserved them.

Rick Major, my senior graphics guy, finally wearied of getting put off whenever he'd ask me about a raise. He decided to go over my head, straight to Craig. The withering look he got told him the whole story. It wasn't going to happen. Rick wisely retreated.

It was a little thing, but it made everybody more aware of just how precarious our situation was. As for me, it made me realize that I needed reassurance too. What did Craig think of the job I was doing? In the early days, he and I had challenged each other regularly; mutual constructive criticism was part of our daily regimen. But now his attention was focused elsewhere. Sure, he was complimentary from time to time and never uttered a harsh word, but I needed more.

I mentioned my concern to Rex one day, almost in passing. Frankly, I was a bit reluctant to bring it up with Craig. What if he hated my stuff? The next day, he called me into his office. Rex had spoken with him. I remember only one word of that conversation: "spectacular." I needn't have worried. I was still the same guy he had hired. Felt good, though.

The problem was that Craig could be intimidating. He didn't mean to be, but he clearly wasn't your average guy. His door was always open; anyone could go in and rap with him about anything. But if you wanted to challenge something he believed in, you'd better have your act together—be able to support your position.

Craig is an active listener and that, I suppose, was part of the problem. You couldn't rattle on for half an hour without interruption. He always wanted to dissect your first point, understand it clearly, and evaluate its implications before you moved on to the next.

Countless times, Joe was asked by others less sure of themselves to confront Craig about something that was troubling them. They'd invariably say, "You go talk to him. He listens to you."

Joe always responded the same way: "His door is open for a reason. Go on in. He'll listen to you too. Just don't babble. Make sure you can support whatever's on your mind. He's going to ask questions, and he'll remember what you say."

If there was one person questioning his status in the company, it was Kyle South. Craig had made it all too clear that Kyle's performance was not up to par. He had a lot of irons in the fire, to be sure, but he was having a terrible time getting his brands to say, "Yes."

Our merchandisers all had a sales quota. It was by no means an impossible goal to reach, for Craig was routinely exceeding it tenfold, and Rex, with no sales experience, was doing almost as well. Bill Hunt and Monica Link met theirs, as did Ken Erickson. Kyle South did not.

In our early days, it was not uncommon for several people to have a hand in the signing of a single vendor. But we were becoming increasingly impatient with Kyle's arithmetic, in which merely having been in the same room with a vendor who'd signed on counted as an "assist."

The partners had no illusions about the value of Kyle's introductions to Lyle Timmon at Madison or to Justin Caise at Caise, Perkins. While they were appreciated, the fact remained that both firms were charging for their services—they were hardly doing us any favors.

South knew in his heart that his days were numbered. But if they had taught him anything in business school, it was how to leverage contacts. If his leaving the firm empty handed wasn't a problem for us, then maybe he could find something—or someone—to exploit that would be. After all, he had put four whole months of his life into this thing.

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The cicadas were starting to sing, and the darkening sky revealed the first of the million or so stars that would soon dust the Virginia sky on this perfect late-summer evening. Joe, Lad, Kyle, and Ken were all relaxing on Lad's deck. But Kyle hadn't come for relaxation. He had come for agriculture: he was about to plant some seeds.

"Boy, Lad," Kyle said. "Must feel good to have that first third of your stock vested already. You and Joe really deserve it, you know? Without you guys, this company would be nowhere."

Joe glanced at him sideways. It had taken total commitment by half a dozen people, and months of hard work from a dozen more, to get the company to where it was now. Sure, tech was important, but….

"Must kind of frost you, though," Kyle said under his breath. "I mean, Winn's buddy Scatena just waltzes in and gets handed thirty percent of the company's stock. You've been here since day one, working your butt off, and you've only got, what, four or five percent?"

"Two." Lad looked up from his beer.

"What?" Kyle asked.

"I have two percent of the company. You're telling me Rex has thirty? What has he done that's worth anything close to thirty percent?"

Joe piped up. "He put up a lot of money really early in the game. Don't you guys know anything about capitalism?"

"It's a question of overall contribution," Kyle snapped back. "From what I can see, Scatena hasn't earned it."

Ken Erickson sipped his beer and didn't say anything. Yet.

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"I'm telling you, Craig, you've got a problem." Ken had cornered Craig downstairs in Commonwealth's little kitchen. He had finished the pot and was about to brew some more. "This has been going on for weeks now. Kyle shows up after work at Lad's house, and they sit around grousing about how the stock distribution is unfair. Kyle's got Lad believing he's under-appreciated. He's building his own Irish green-eyed monster. I have no idea why."

"I do," Winn said, frowning. "What about Joe? Is he in on this?"

"Joe has been there on several occasions. He's Lad's bud. Doesn't say much. I've heard him defend your position once or twice, but Lad is more susceptible."

"Thanks, Ken," Craig said softly as he picked up his coffee cup. "Keep me posted, would you? Make it seem like you're with 'em."

"Sure. I didn't want to see you get blind-sided."

Winn was furious, but he did his best to hide it. When he got back upstairs and sat down at his desk, his hand was trembling, spilling coffee. Get hold of yourself, man. He asked Rex to join him in his office and closed the door.

"I don't know exactly what's coming," Craig said, "But it is coming. Kyle is planning some kind of mutiny. Erickson's been hanging out at Lad's, watching this thing build for a couple of weeks, playing along. It appears that Kyle has come to the conclusion he's on his way out, and he wants to either leave with his pockets full or somehow force us to keep him on. Damn! I just hate these games!"

"So what's he got for a bargaining chip?"

"Not what. Whom. He's got our brilliant but naïve Lad McCaile all worked up about his ownership percentage. He has him convinced that he's due more stock. And the bone of contention…"

"Don't tell me," Rex said. "It's me and my thirty percent."

"You got it, pal." Craig almost spat out the words. "They have no conception of how capital works. They have no grasp of what it's like to plunk down your savings on an idea—to leave your own business and work fourteen-hour days for no salary at all, trying to get something going. Think they'd sign a personal guarantee for a quarter million dollar equipment lease? I've explained stock ownership and options to them 'til I'm blue in the face. They just don't get it."

"Okay, calm down. Knowing it's coming is half the battle. Let's look at the likely scenarios. What's Kyle going to ask for? What's Lad going to want? How does Joe figure into this? Can Kyle hurt us?"

Craig blanched at that last question. "He's close to three of the five investors in our venture round. They're all Darden grads."

"What if one or more of them decides to bail?" Rex asked. "Will the round survive?"

Winn knew the answer but elected to change the subject. "Kyle's not pulling his weight. His departure wouldn't even be a mosquito bite. Lad's leaving would be more like getting run over by a buffalo—we'd survive, but it would really hurt. But if Joe leaves, we're dead."

"We need to find out what he's thinking," Rex said. "Right now."

Joe was whisked into Craig's office, pumped for information by our worried founders, and offered a raise and more option shares if he'd stay. "Look, thanks for the offer, but this really isn't necessary. I know you're worried about Lad leaving, and you're right to, 'cause he is thinking about it. He doesn't want to. He really likes it here. He's just concerned that he's not getting a fair shake. Lad knows Kyle is gonna get fired if he doesn't quit. But you don't have to worry about me. I'm not going anywhere. I believe in what we're doing. Besides, you can't afford it."

"You got that right." Craig and Rex breathed a collective sigh of relief. "You don't know how pleased we are to hear you're not bailing on us."

"Oh, I probably have some idea," Joe smiled. "Look, Lad is my best friend in Charlottesville. Outside of work, we play soccer and hockey together, go dirt biking, that sort of thing. That doesn't mean I agree with him. He's got this idea that in an Internet business, the geeks are the most important thing. Kyle is in there fanning the flames. Lad has a point, I suppose, but our company is a lot more than its technology."

"That it is," Rex agreed.

“I wouldn’t characterize Lad as being evil here,” Joe continued. “He just thinks the stock allocation isn’t fair. He doesn’t know much about the value of capital, and he’s conveniently forgotten that he’s been drawing a salary all along. I’ve tried to talk to him, but…”

“Okay, Joe,” he said. “Worst cast scenario. Can we make it if Lad leaves? Do you know the back end well enough to continue building it?”

Joe thought for a moment. “Yeah, I think so. I’ve spent an awful lot of time on the back end. I know how it works. We’ll make it.”

As Joe got up to leave, they stopped him. “We want to thank you for not holding us hostage. You’re a class act. As our way of saying thanks, Rex and I have decided to give you another one percent of the company.”

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Erickson glanced behind him as he walked into Craig’s office, making sure no one else was within earshot. “Tomorrow morning,” he said. “Lad and Kyle are planning to hit you with their ultimatum tomorrow, first thing.”

“Okay. Thanks for the heads up.”

Craig and Rex met early the next morning.

“Here’s how it lines up. The due diligence is done, with a valuation of thirty-five million. The round is due to close tomorrow.” The founders were sitting at the round antique drop-leaf maple table in Craig’s office. Papers were everywhere, in semi-neat stacks on the table and the floor nearby. “The lead investors are in for two million apiece. So is CapOne. Allied Capital is in for one. Smithers is investing five hundred thousand. That comes to seven and a half million on a thirty-five million valuation.

“That’s the good news,” Craig continued. “The bad news is that any minute now, Kyle and Lad are going to walk through that door and make their demands. This isn’t going to be pretty.”

As if on cue, Kyle South popped his head in the door. Lad McCaile was standing beside him.

“Come on in, guys,” Rex waved them in. When Lad saw that Rex was there, he hesitated, but it was too late. He followed Kyle into the room. “Have a seat. What can we do for you?”

Kyle and Lad glanced at each other. Lad spoke first. “We feel that there are some inequities in the way the stock has been distributed. It doesn’t accurately reflect the contribution of every employee.”

“Meaning you two,” Craig offered.

“Ahh, well, yes,” Lad’s speech had been rehearsed, and Craig had thrown his timing off. “Among others, I mean.” His prepared text was out the window; he’d have to ad lib. The bottom line was simple. He wanted more stock—a lot more—and he wanted all of it vested immediately.

He felt that since we were a tech firm, the techies should get a bigger slice of the pie. With that picture in mind, he produced a sheet of paper and drew a circle on it. “This circle represents the company,” Lad said. “Draw a pie chart that shows the value of each person’s contribution.”

Craig wouldn't bite. "I'm not going to do that, Lad. It's clear that you have a fundamental lack of understanding about the value of capital, of sales, of marketing, of partnerships. You're a great guy and a darn good DBA, but you're inexperienced in business matters. You've had no exposure to the entrepreneurial environment, to capitalism, to incentive stock options. I trust you will someday. Kyle here's a Darden grad. I'm surprised that he hasn't enlightened you."

South said nothing.

"As far as vesting all your shares immediately, asking us to do that belies a fundamental misunderstanding of the nature of incentive stock ownership. Forget the fact that our agreement clearly delineates a vesting schedule spread out over three years. The whole point of an incentive stock option plan is incentive. It's a reward for hanging in there, finishing the job, doing your part to make the company successful. As far as day-to-day contribution, that's why you're paid a salary. Salaries, by the way, are something that neither Rex nor I have enjoyed. In fact, it's our money that's paying yours."

They talked for some time, the founders trying to convince Lad that he was being given a fair, even generous deal in light of the circumstances. Lad tried to get them to see things his way. It was clear that, even though he wouldn't name a figure, he thought his two percent was off by an order of magnitude. Also, the concept of his percentage being diluted by raising capital through private equity funding was impossible for him to grasp. Lad dug in his heels and refused to budge.

Craig looked at Kyle, who as yet had contributed nothing to the discussion. "And what about you, Kyle. What do you want?"

South sat up a little straighter. "I feel pretty much like Lad, that my talents and contributions are being shortchanged. I've worked hard for this company, and I've introduced you to some very important people. That has value, whether you realize it or not. Bottom line, I want my shares to vest immediately, based upon my overall contribution."

"We can't do that, Kyle. Not for you, not for Lad, not for anybody."

Kyle put both hands on the table, pushed his chair back, and rose. "I thought you might say that. I've stated my position in a letter. I'll email it to you. As you consider my conditions, I suggest that you keep in mind that several of the key players in this investment round are looking to me for guidance. After all, what can I tell my fellow Darden alumni if I no longer have faith in the soundness of their proposed investment?"

Craig's voice remained calm. "Are you blackmailing me, Kyle?"

South smiled slightly. "No, of course not. Just negotiating."

"Negotiation," Craig said coldly, "is where I offer you something good in exchange for something good in return. Tough negotiation is offering something that's sort of good in exchange for something very good. But when you say 'Give me a good thing, or I'll do something bad to you,' that's blackmail. Think about that before you send your email."

Kyle and Lad left Craig and Rex to absorb the implications of what had just transpired. Rex lamented, "I thought this might get ugly, but…."

After an hour or so, Craig checked his email. "Message from Kyle South. Here it is." He opened it up with Rex looking over his shoulder.

"Blah, blah, blah, vendors that I played a key role in securing… Eighty-seven thousand dollars! I'll buy his role in signing Samsung, Hitachi, and UUNET. These would total, let's see, twenty grand. The rest of these, GBC, Sanford, Targus, he played a minor role, if any."

"I signed most of these myself," observed Rex. "Bill signed these two. Where does this guy get his numbers?"

Craig read on. "Stuff that might close within sixty days…more accounts that he thinks he should get credit for…okay, here are his demands—excuse me, his 'proposals.' One, we pre-vest his shares. Fat chance on that. Two, 'If we can put together a mutually agreeable severance package…blah, blah, he promises to be a good boy…. Oh, shit! Look at his third point, Rex. 'I will assist in keeping the financing process on track and attribute my leaving the company to a combination of personality issues (differences in management style) and family issues.'"

"In other words," Rex analyzed, "If we don't give him a severance package for his four-month tenure here, he'll do everything he can to derail the venture capital round. He'll go to all his Darden contacts and tell them that the company isn't viable without Lad McCaile."

Craig slumped in his chair. This can't be happening.

"So what do we do next?" Rex queried.

"First we accept Kyle South's resignation. Then, damage control. Who's from Darden? Let's see, there's Lyle Timmon, from Madison…."

"The lady from Jefferson Capital, Chip from Allied Capital…."

"Right, and if you can believe it, the Treasurer and CFO of CapOne is from Darden. The deal doesn't go through without his sign off."

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"They sure didn't waste any time." Rex was sprawled in one of the chairs near the antique table. His eyes were glazed over.

Craig read the score. "One terse note. One phone call from an underling who doesn't know anything about us. Of the lot, only Smithers is even willing to talk about it. Rich Fairbank isn't returning our calls. The Jefferson lady isn't available—like hell she isn't. It's like we've got leprosy or something. Rex, my friend, I'm afraid we're screwed."

"Yeah. "How could people who were so positive one minute turn so negative the next? How could one slick Richmond blue blood and a naïve Irish immigrant do so much damage in, what, twenty-four hours? They never moved that fast when they worked here."

Despite himself, Craig had to smile at that. You almost had to admire the efficiency of their treachery. What had taken months to build had been torn apart in a matter of hours. He sighed. "When you have too little information, bad information can be very seductive."

The founders had no idea how fraught with portent those words were. They had more pressing things on their mind. Craig got back to business. "I've been keeping Timmon and Caise appraised of the situation ever since Ken gave us the heads up. Right now, I don't even know where they stand. I only know three things. One, we're almost broke. Two, Caise and Timmon are the only two people on God's green earth who might be able to breathe some life back into our funding round. And three, both of those guys are in tight with Kyle South."

“Well,” Rex said. “Looks like you were right about one thing.”
“What’s that?”
“We’re screwed.”