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The Reasonable Term Trap

Why "standard-sounding" clauses create predictable founder wipeouts, and how to detect them before signing.

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Not legal, tax, or accounting advice. This is an educational synthesis of research and practice patterns.

The Most Dangerous Word in a Term Sheet

In venture and M&A, “reasonable” is not a property of a term. It is a feeling produced by complexity, time pressure, and anchoring to whatever the other side presents first.

The economic and legal reality is simpler: many of the outcomes that surprise founders are predictable once you map (1) who controls the levers that determine the outcome, and (2) how verifiable those outcomes are. This brief explains why terms that sound fair in isolation can still produce founder wipeouts—without requiring bad intent from the other side.

What the Research Shows

Venture and acquisition agreements do not allocate “rights” as a single bundle. They unbundle and separately assign cash-flow rights, control rights, and information rights—and those bundles interact in ways that contract language alone cannot fully specify. [1]

Contracting theory predicts, and empirical work confirms, that in high-uncertainty settings—where many future states cannot be specified in advance—residual control rights matter more than written obligations. The party that controls decision-making authority in unspecified states shapes outcomes in those states, regardless of what the contract says about good faith. [2]

Earnouts can bridge valuation gaps when buyer and seller disagree about growth or integration outcomes. But they also create post-close incentive conflicts: the earnout metric usually sits inside an operating environment that the buyer controls. A systematic review of the earnout literature (1970–2023) documents post-close conflict as a recurrent pattern, not an exception. [3]

Liquidation preferences and participation rights can make it mathematically possible for founders and common holders to receive zero in an exit that looks like a success on the press release. Empirical work on VC-backed sales documents priority deviations and carve-outs that redistribute proceeds away from common holders in ways not visible from headline deal terms. [4]

Negotiation research shows that anchoring (over-relying on the first number or term offered), framing (evaluating terms relative to a reference point rather than independently), and reactive devaluation (discounting proposals from the other side) are documented and predictable. “This is standard” is the single most powerful anchoring phrase in deal negotiations. [5]

The practical fix is not cynicism. It is design discipline: define states, map control, harden metrics, model the waterfall. The tools are available. Most founders do not use them.

The Four Rights That Decide Outcomes

Most deals allocate four families of rights. The failure mode is rarely one term in isolation; it is the interaction of these rights across realistic future states.

- **Cash-flow rights:** Who gets paid, when, and in what order. These include dividend rights, distribution waterfalls, and participation features that allow some investors to be paid twice.
- **Liquidation rights:** What happens at exit. Priority, preferences (1x, 2x, participating, non-participating), caps, and conversion thresholds. The math matters more than the label.
- **Control rights:** Who makes operating and strategic decisions. Board composition, protective provisions, consent rights, voting thresholds, and founder veto rights—or their absence.
- **Information rights:** Who can see what, and when. Reporting cadence, access to financial data, audit rights, and metric verification rights determine whether you can detect a problem before it becomes unrecoverable.

A term that is "reasonable" on paper can become lethal when control and information rights allow the other side to reshape the outcome after signing.

Why "Reasonable" Fails: Three Structural Mechanisms

Three mechanisms, drawn from contract theory, agency theory, and behavioral economics, explain why terms that feel fair at signing can produce outcomes that feel like fraud—but are not.

Mechanism A: Incomplete Contracts and Residual Control

In high-uncertainty environments, contracts cannot specify every contingency. Contract theory focuses not on what the contract says but on who controls decisions in situations the contract did not anticipate. [2] The party holding residual control rights—the right to make decisions in unspecified situations—determines outcomes in those situations.

In practice, this means that the party holding residual control rights can legally reshape the operating environment in ways that affect performance metrics, without breaching any written obligation.

> **Concrete example:** A founder sells a company with a $30M earnout tied to revenue targets. Post-close, the buyer shifts the channel strategy, reassigns the sales team, and raises prices. None of these actions breach the merger agreement. The revenue target is missed. The earnout pays nothing. No contract was violated.

Mechanism B: Moral Hazard and Multi-Task Measurement

When effort and performance are hard to observe, incentives shift behavior in predictable ways. Holmström's foundational work on moral hazard [6] and the Holmström-Milgrom multi-task framework [7] show that when only some dimensions of performance are measured and rewarded, agents rationally optimize toward the measured dimensions and away from unmeasured ones.

This is not "cheating." It is a predictable response to measurement and incentives. When the buyer's internal priorities diverge from the earnout milestones, the buyer's team will rationally allocate resources toward internal priorities.

> **Concrete example:** An earnout is tied to annual revenue with a $20M Year 1 hurdle. The acquired product is on pace to hit $18.5M. The buyer's sales team is also responsible for two other product lines with quarterly quotas. In Q4, the sales team prioritizes the products with clearer internal incentives. The earnout product finishes at $17.8M. The hurdle is missed by $2.2M. No one acted in bad faith. The structure produced the outcome.

Mechanism C: Negotiation Heuristics Replace Modeling

Negotiation research documents predictable judgment errors: anchoring, availability, framing, reactive devaluation, and the "standard" shortcut. [5] Founders operating under time pressure, with legal bills accumulating and investors signaling urgency, are in precisely the conditions where these biases are strongest.

The most dangerous heuristic is the "standard" shortcut. When a lawyer or investor says "this is standard," the statement may be accurate—the term may appear in many comparable agreements. It does not mean the term is appropriate for your specific deal, your specific leverage position, or your specific risk profile.

> **Concrete example:** A founder accepts a "standard" drag-along provision because their lawyer confirms it appears in most Series B agreements. Two years later, the lead investor exercises the drag-along to force a sale at a price that recovers the preference stack but leaves common with minimal proceeds. The provision was standard. The outcome was not what the founder modeled.

Earnouts: What They Solve and What They Create

What earnouts solve: information asymmetry and valuation disagreement. When buyer and seller disagree about growth trajectory, integration potential, or regulatory outcomes, contingent consideration allows the parties to close a transaction that would otherwise fail on price.

What earnouts create: post-close incentive and discretion problems. The earnout metric usually sits inside an operating environment that the buyer controls after closing. The buyer has both the ability and, in some cases, the incentive to reshape that environment in ways that affect the metric.

The key questions are not "Is the earnout fair?" The key questions are:

- Who controls the levers that determine the metric?
- How verifiable is the metric, and by whom?
- What operating covenants prevent diversion or resource starvation?
- What is the dispute path (expert determination vs. court) and the timeline?

Worked Example: How a "Fair" Earnout Fails

> A founder sells for $100M upfront + $40M earnout tied to Year 1 and Year 2 revenue targets. The deal closes.
>
> Post-close, the buyer: (1) reassigns 3 of 5 senior sales reps to a different product line; (2) raises prices 20%, reducing unit volume; (3) delays a product update the sales team had been relying on to close enterprise deals.
>
> The founder hits 78% of the Year 1 target. The earnout provision pays nothing below 90%. The buyer has not breached the merger agreement. No litigation is viable without years of discovery to prove intent.
>
> **The earnout was "reasonable." The outcome was $0.**

Preference Stacks: How Founders End Up at $0 Without Fraud

Founder wipeouts can occur in ordinary exits because payout is determined by priority and conversion math, not headline proceeds. Liquidation preferences, participation rights, and seniority stacks create incentive misalignment between preferred and common holders. [4, 8]

This creates predictable incentive conflict:

- Preferred holders may prefer a sale that returns their preference even if it leaves common with little. [8]
- Common holders may prefer riskier continuation that preserves upside optionality.

This misalignment is strongest near the preference and conversion thresholds: the zone where preferred holders are indifferent between conversion and preference—and where the difference for common can be substantial.

Worked Example: The $80M "Success" That Pays Founders Nothing

A company raises three rounds totaling $50M invested:

- Series A: $10M at 1× non-participating preferred
- Series B: $15M at 1× participating preferred (no cap)
- Series C: $25M at 1× participating preferred (no cap), senior to A and B

Founders hold 30% of common. The company sells for $80M.

Payout waterfall:

Step	Payout
Step 1	Series C takes $25M (senior preference). Remaining: $55M.
Step 2	Series B takes $15M (preference). Remaining: $40M.
Step 3	Series A takes $10M (preference). Remaining: $30M.
Step 4	Series B and C participate pro-rata in the remaining $30M alongside common. Series A converts (non-participating). After participation, founders' share of the remaining pool is significantly diluted by participating preferred double-dipping.
Result	On the press release: "$80M exit." At the cap table: founders receive a fraction of what the headline implies. No fraud occurred. No covenants were violated.

The practical takeaway: founders must model a waterfall across realistic exit values and dilution paths, not just the top-line headline. The press release and the cap table tell different stories.

Control Terms and Board Rights: The Quiet Allocator

Control is often sold as governance hygiene. In practice, it is also allocation power under uncertainty. [10] Control rights determine whether the company continues, sells, raises, pivots, hires, cuts, or reallocates resources. When outcomes are uncertain, the party with control rights shapes which outcomes materialize.

A founder should treat control terms the way an engineer treats a control system:

- Identify who has authority in each state (growth, stall, downturn, default).
- Identify what constraints apply to each decision-maker.
- Test for failure modes: “metric hostage,” “budget starvation,” “strategic deprioritization,” “forced sale at preference.”
- Map what happens when multiple triggers fire simultaneously (e.g., missed revenue target + new financing need + board seat shift).

The Diagnostic: Control × Verifiability

Every deal can be plotted on two axes. This grid is the single fastest diagnostic for identifying where “reasonable” terms become structural hazards.

Quadrant	Interpretation
Lower-left (Founder controls + hard metrics)	The founder retains the operating levers, and the metrics are objectively measurable. Lowest risk quadrant. Standard contract protections are generally sufficient.
Upper-right (Buyer/Investor controls + soft metrics)	The other party controls the levers that drive the metric, and the metric is discretionary or internally computed. Highest risk quadrant. Structural mechanisms are required—not just covenants.
Off-diagonal quadrants	Manageable with design work. If the buyer controls levers but metrics are hard (lower-right), the hardness of the metric provides partial protection. If the founder controls levers but metrics are soft (upper-left), the founder’s control provides partial protection.
Mitigation in the high-risk zone	Must be designed before signing: operating covenants, hardened definitions, audit rights, dispute mechanisms, and—where possible—structural mechanisms (reversion, independent subsidiary, on-time bonus) that make sabotage irrational rather than merely prohibited.

Five Stress Tests Before Signing

1. State-Space Walkthrough

List 8–12 plausible futures: integration works, integration stalls, macro shock, product delay, channel conflict, budget cut, leadership change, regulatory delay. For each state, map who controls the decision, what the financial outcome is, and whether the contract language addresses it.

2. Metric Hardening

Define every performance metric as if you expect a dispute, because statistically, you should. Include: worked examples, accounting principles, exclusion lists, treatment of extraordinary items, and the verification mechanism. If the definition fits on one page, it is probably underspecified.

3. Lever-Control Audit

Identify the top 10 operational levers that drive the KPI (budget, headcount, pricing, channel priority, product roadmap, sales team composition). For each lever: who controls it post-close? What contractual constraint limits misuse? What is the remedy if the constraint is violated?

4. Waterfall Modeling

Run exit waterfalls across at least three valuations: downside (1–2× capital raised), mid-case (3–4×), and upside (8–10×). At each valuation, model the full cap table including all preferences, participation features, anti-dilution adjustments, and option pool. The headline number is not your number.

5. Remedy Realism

Assume no court will “fix” an unclear term quickly or cheaply—or at all. The Auris Health–Johnson & Johnson earnout litigation ran seven years, produced a 10-day trial, 33 witnesses, and a Delaware Supreme Court appeal. Even a win takes years and costs millions. Design the deal so you do not need the court.

The Checklist

Use this before you sign.

Earnouts

- ☐ Who controls the levers that determine the KPI (budget, headcount, pricing, channel, roadmap)?
- ☐ Are KPI definitions objective, consistent, and audit-ready (examples, exclusions, accounting principles)?
- ☐ What information and audit rights exist (cadence, access, source systems)?
- ☐ Are there operating covenants preventing diversion or resource starvation?
- ☐ What is the dispute mechanism (expert vs. court), timeline, and standard of review?
- ☐ Are there acceleration/deemed-achievement triggers for certain buyer actions?

Preference / Liquidation

- ☐ Have you modeled a waterfall across realistic exit values (not just “success”)?
- ☐ Is preferred participating? Is there a cap? Are dividends accruing?
- ☐ What seniority stack exists? Any pay-to-play or milestone conversions?
- ☐ Where is the conversion threshold, and who has incentives near it?

Control / Governance

- ☐ When do control rights shift (performance triggers, financing, covenant breach)?
- ☐ Who can replace the CEO, and under what conditions?
- ☐ What actions require investor/buyer consent (budget, hires, financing, M&A, IP)?
- ☐ Is there a truly independent director? How is the seat chosen?

Bias-Proofing

- ☐ What would have to be true for this term to hurt us? (pre-mortem)
- ☐ What is the single most gameable metric in this deal?
- ☐ What “reasonable” assumption are we making that we have not tested?

Annotated Reading List

High-signal academic and practitioner sources. One-line descriptions for orientation.

Kaplan & Strömberg (2003). Empirical VC contracts; demonstrates separable allocation of cash-flow and control rights across financing rounds. Foundational for understanding why "rights" are not a single bundle.

Aghion & Bolton (1992). Incomplete contracts and contingent allocation of control; foundational model for understanding residual control in high-uncertainty settings.

Holmström (1979). Moral hazard and observability; core framework for incentive design under imperfect information.

Holmström & Milgrom (1991). Multi-task incentives; why strong incentives on one KPI can distort behavior across other dimensions. Essential for earnout design.

Dahlen (2024). Systematic literature review of earnouts across 1970–2023; documents post-close conflict patterns and measurement issues.

Broughman & Fried (2010). Renegotiation of cash-flow rights in VC-backed sales; how priority deviations and carve-outs redistribute proceeds.

Sanga (2021/2024). Fiduciary duties near liquidation preference thresholds; incentive conflicts between preferred and common holders in VC-backed exits.

Fried & Ganor (2006). Agency costs of VC control in startups; scope of consent rights and board dynamics.

Bratton (2002). Preferred stock mechanics and corporate control on the downside; how protective provisions shift power.

Guthrie (2004); Tsay & Bazerman (2009). Heuristics and biases in negotiation; anchoring, framing, and reactive devaluation in deal contexts.

Notes

[1] Kaplan & Strömberg (2003). Review of Economic Studies. Empirical analysis showing VC contracts separately allocate cash-flow, voting, and board rights.

[2] Aghion & Bolton (1992). Review of Economic Studies. Demonstrates that when future states are unspecifiable, control-right allocation determines outcomes.

[3] Dahlen (2024). Management Review Quarterly. Systematic review of earnout literature 1970–2023, documenting post-close conflict as recurrent pattern.

[4] Broughman & Fried (2010). Journal of Financial Economics. Empirical study of how liquidation preferences and participation rights redistribute proceeds.

[5] Guthrie (2004); Tsay & Bazerman (2009). Documenting anchoring, framing, and availability heuristics in negotiation contexts.

[6] Holmström (1979). Bell Journal of Economics. Foundational moral hazard paper on observability and incentive design.

[7] Holmström & Milgrom (1991). Journal of Law, Economics, & Organization. Shows how strong incentives on one dimension distort behavior on others.

[8] Sanga (2021/2024). Analysis of fiduciary duties and incentive misalignment near liquidation preference thresholds in VC-backed startups.

[9] Weinstein et al. (2023). Fried, Frank practitioner synthesis documenting rising earnout incidence and dispute frequency.

[10] Fried & Ganor (2006). NYU Law Review. Agency costs of VC control in startups, including board dynamics and consent-right scope.

[11] Bratton (2002). Michigan Law Review. Analysis of preferred stock mechanics and corporate control on the downside.

Selected References

Kaplan, Steven N., & Strömberg, Per (2003). “Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts.” *Review of Economic Studies.*

Aghion, Philippe, & Bolton, Patrick (1992). “An Incomplete Contracts Approach to Financial Contracting.” *Review of Economic Studies.*

Holmström, Bengt (1979). “Moral Hazard and Observability.” *The Bell Journal of Economics.*

Holmström, Bengt, & Milgrom, Paul (1991). “Multitask Principal–Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design.” *Journal of Law, Economics, & Organization.*

Dahlen, Niklas (2024). “Earnouts in mergers and acquisitions: a systematic literature review of a contingent payment mechanism.” *Management Review Quarterly.*

Weinstein, Gail et al. (2023). “Earnouts Update 2023.” Fried, Frank practitioner synthesis.

Broughman, Brian J., & Fried, Jesse M. (2010). “Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms.” *Journal of Financial Economics.*

Fried, Jesse M., & Ganor, Mira (2006). “Agency Costs of Venture Capitalist Control in Startups.” *New York University Law Review.*

Bratton, William W. (2002). “Venture Capital on the Downside: Preferred Stock and Corporate Control.” *Michigan Law Review.*

Sanga, Sangasarath (2021/2024). “Fiduciary Duties in Venture Capital-Backed Startups” / “Don’t Go Chasing Waterfalls.”

Guthrie, Chris (2004). “Heuristics and Biases at the Bargaining Table.” Negotiation symposium essay.

Tsay, Chia-Jung, & Bazerman, Max H. (2009). “A Decision-Making Perspective to Negotiation.” *Negotiation Journal.*

About AEIOU Academy

Eliminating Structural Risk so that founder outcomes are determined by whether they built something valuable, not by whether they understood the fine print.

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