**Board members face a blackmail dilemma

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The following case is based on true stories that I was personally involved with in three similar instances the past fifteen years. The names of the company and the individuals are made up here. The real stories were much more complicated with one of these cases involved some criminal activities that required police intervention.

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Artificial Minds Inc (AMI) was a fast system that facilitates complex AI algorithms to be accelerated via a special hardware chip. The core group of founders brought to the table a strong mix of skills sets that together destined AMI to a bright future.

The three co-founders are:

Rick Patel. An Indian born. Educated in the U.S. A former Boston Consulting Group Partner. Serving as CEO.

Vladimir Smirnoff (Vlad). Educated in the Russian Federation. A former IBM scientist. Vlad is the technical guru behind this technology. Vlad also served as the de-facto IT person in the office.

Rachel Smith. Educated in the U.S. A former marketing executive at American Bank. Serving as the VP Marketing and Business Development of AMI.

The basic idea behind the technology is the notion that if an algorithm is too complex to be processed by a general purpose computer, a targeted hardware accelerator that is optimized to process this specific algorithm will perform the task much faster and for less cost. Both Vlad and Rick worked on similar ideas with their previous employers. They met at a conference few years back. Vlad and Rick joined forces and together with Rachel, a college friend of Rick, started AMI in 2015. Vlad built a software simulator to prove the technology and its performance acceleration impact. The market potential is huge as it is expected to have thousands of these accelerators in the cloud, as well as an add on attachment to people’s personal computers.

AMI raised a $600K seed round early 2016. The investors were VC A, VC B, and VC C. Each of these VCs acquired 20% equity. The three co-founders were diluted to 10% each. The remaining 10% was assigned as ESOP for the future employees. The new Board of Directors had one representative from each of the investors, plus two representatives from the co-founders. According to the Article of Association the co-founders will elect their two representatives for the BoD at the end of March of each year.

The first two board members from the co-founders were Vlad and Rick. The next election time was supposed to be March 30, 2017. The cofounders decided among themselves to draw only a very modest $2K monthly paycheck each. They also used part of the new investment to hire two young engineers at a fair market salary of $5K/month, with each of them allocated 0.5% of the ESOP to be vested over two years.

The technical team led by Vlad plus the two junior engineers spent the next several months designing and building few hardware prototypes as proof of concepts for the investors, and for customers demonstrations. Vlad partitioned the engineering work in such a way that the junior engineers did not acquire a good understanding of the basic technology, only their limited scope in the implementation. The “secret sauce” was all in Vlad’s head.

During this period Rachel spent her time networking with potential customers and acquiring their feedback to the concept. The responses were encouraging. Once the prototypes became available in the fall of 2016, Rachel took them to run benchmarks with several customers, and the results proved 100X acceleration of running the same algorithms on the AMI accelerator vs running them on a general-purpose computer. The future of AMI looked very rosy at this point.

The operational expenses took an obvious toll on their bank account however, and they had to rush into a next round of fund raising using the recent customers’ interests and actual benchmarks’ results as a technology feasibility proof a confirmation of market interest. The burn rate of the company was expected to take their cash balance to zero around May of 2017.

The recent successes of AMI in building the prototype and gaining customers enthusiasm for the technology made the fund raising effort relatively easy. The three existing investors offered to invest $8M in AMI at a valuation of $10M. This proposal should have diluted the founders to 2% each, still double the $ value of their equity from the previous round.

The Articles of Association required 100% board votes to accept a new investment. Rick and Rachel were very enthusiastic about the new investment opportunity; however, Vlad was not. Vlad insisted that as the main brain behind the technology, and as the only one that really understands it, he should be awarded 5% equity in the new round, otherwise he will vote against it, furthermore, he threatened to quit which will practically kill the company. Although the intellectual property officially belongs to the company, much of it is in Vlad’s head, thus without him the company can’t practically continue its operation.

The board meeting to vote on the new investment was supposed to take place Dec/15, 2016.

Discussion points:

>> What can the investors (plus rick and Rachel) do now to resolve this deadlock?

>> How can investors mitigate this one person risk ahead of a crisis?