

Private Equity and Venture Capital Investment Agreements

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Scope of Presentation

- Deal structure
- Essential elements of a term sheet
- Due diligence –how much is enough?
- Equity purchase agreements and terms
- Warrants: when to include

Scope of Presentation

- Management equity
- Down-road financing issues
- Exit issues
- Sample clauses

What is Private Equity?

- Purchase of securities not qualified by prospectus
- Angel investors a type of private equity capital
- PE funds most often private pools of capital, structured as limited partnerships
- Some PE funds are public companies (Onex Capital)

What is Private Equity

- An experienced PE manager as GP, with pension funds, other institutional investors and high net worth individuals as LP's
- Funds tend to specialize - seed, start-up, growth, mezzanine, leveraged or non-leveraged buyouts, turnarounds and distressed company funds

What is Private Equity?

- Angel and venture capital are types of private equity
- Angel investments tend to range between \$250,000 and \$1.5 million
- VC investments typically run from \$1.5 million and up, increasingly in later stage companies
- PE typically larger, later- stage investments

Deal Structure

Factors influencing deal structure include:

- stage of development of target company
- involvement of Founder / Entrepreneur
- professional management / management participation
- number of existing shareholders
- number of prior rounds
- stock or asset deal
- valuation issues
- risk management

Deal Structure

“Isolate the biggest risk in the deal and structure the initial investment so the money is used to eliminate that risk.”

Anthony Perkins, VC Investor

Deal Structure

PE / VC investors will structure hedging strategies to minimize downside risk and co-investment strategies to share risk

Deal Structure

Areas of risk

- Management
- Product
- Market
- Operations
- Financial

Deal Structure

Financial tools for managing risk:

- Share attributes
 - Common or convertible preferred equity
 - If convertible,
 - either at a fixed number of shares or a percentage of shares outstanding at a future date
 - normally includes a fixed dividend
 - gives preference over commons (Founders) in the event of liquidation or merger

Deal Structure

- Convertible debt
- Debt financing with equity kicker
- Options and warrants
- Staged (milestone) investment

Deal Structure

Non-financial tools for managing risk:

- Right to board seat or observer status
- Contractual right to company information
- Retraction rights
- Anti-dilution rights
- Pre-emptive rights
- Carry-along / tag-along rights

Term Sheet Essentials

- A self-contained summary of the deal
- Level of detail always open to debate, but a term sheet should be:
 - a useful road map for the drafters; and
 - a reliable reference source for the principals (assuming deal doesn't change on closing)

Term Sheet Essentials

- Key Issues
 - Financial terms
 - price (valuation methodology)
 - pre-money valuation
 - capitalization table (especially if warrants outstanding)
 - dividends / interest coupon
 - warrants / options

Term Sheet Essentials

- Security attributes
 - dividend rights
 - voting rights
 - liquidation preference
 - conversion terms
 - redemption rights
 - retraction rights

- Anti-dilution protection

Term Sheet Essentials

- Pay-to-play provisions
- Resale restrictions
 - carry-along / tag-along rights
 - rights of first refusal
 - co-sale agreement

Term Sheet Essentials

- Prohibition on certain conduct
- Access for due diligence
- Information rights
- Voting rights / blocking rights
- Proprietary information
- Payment of expenses
- No shop / exclusivity

Term Sheet Essentials

- Founders' activities
- Key employee lock-ups
- IPO share purchase
- Indemnification
- Assignment
- Walk-away rights
- Confidentiality

Term Sheet Essentials

- Deal non-binding, but certain provisions should be made binding
- Must be explicit about what is binding

Term Sheet Essentials

Binding provisions:

- expense reimbursement / break-up fee (if there is one)
- No-shop / exclusivity clause
- prohibition on certain conduct (ordinary course activity / no long-term commitments)
- due diligence access / disclosure
- confidentiality

Term Sheet Essentials

- Walk-away rights should be explicit
- Don't rely on the due diligence condition for walk-away rights, such as board approval or debt financing

Due Diligence

- A process to identify business and legal investment risk
- Business due diligence can identify areas of concern for legal due diligence
- Seller's own due diligence
 - preferably before negotiations commence
 - to identify and manage risk
 - basis for limiting or qualifying representations in agreement

Due Diligence

- qualifications will limit Seller's /Founder's exposure to post-closing claims
- issues not identified by Seller/Founder early in negotiations may either scare off investor or be used by investor to renegotiate price and terms

Due Diligence

- Due diligence is time consuming and expensive
- Pressure to reduce due diligence
 - to minimize costs
 - to make the process less adversarial
 - to get to signing/closing more quickly
- On the other hand, issues that arise late in the process can be more difficult or expensive to resolve than at DD phase

Due Diligence

- Key due diligence issues:
 - third-party consents and approvals
 - existing debt/equity arrangements
 - provisions in Articles / share rights
 - existing shareholder/investor agreements
 - material contracts
 - affiliate issues
 - liens and encumbrances

Due Diligence

- environmental concerns
- litigation
- intellectual property issues
- special regulatory issues
- change of control issues

Equity Purchase Agreements & Terms

- **Cap Table**
 - all securities, warrants, options & terms including vesting periods & strike prices
- **Multiple Investors**
 - lead investors
 - ‘majority in interest’ investors
 - which are deal critical? / who determines investor interests?

Equity Purchase Agreements & Terms

- Termination Rights
 - especially where multiple investors
- Decision-Making & Control
 - right to board seats
 - when, if ever, can investors take control?
 - contractual right to receive continuous disclosure of material information

Equity Purchase Agreements & Terms

- **Reps & warranties**
 - negotiation of qualifiers, such as knowledge or materiality
 - survival period
- **Deal specific reps & warranties**
 - For example, IP or financial statement disclosure

Equity Purchase Agreements & Terms

- Indemnities
 - negotiation of limitations on quantum, duration and types of damages exposure
 - caps, baskets, exclusions

Equity Purchase Agreements & Terms

- Remedies
 - reps > tort damages
 - warranties > breach of contract; rescission
 - limit rescission rights?
 - indemnity as exclusive remedy absent bad faith or fraud
 - liquidated damages?

Equity Purchase Agreements & Terms

- Length of time between sign and close
 - provisions related to conduct
 - ordinary course / no material changes (MAC clause)
 - assistance with obtaining third party consents
 - good faith efforts to complete closing
- VC investments
 - expense reimbursement

Equity Purchase Agreements & Terms

- Other provisions
 - expense reimbursement
 - company use of proceeds
 - add-on investments
 - if milestones met, pricing and terms of milestone funding is fixed to avoid duplication of costs

Collateral Agreements

- Investor Rights Agreements
- Indemnification Agreements
- Employment Agreements
- Confidentiality / Non-Disclosure Agreements
- Non-Compete / Non-Solicitation Agreements
- Voting / Control Agreements
- Unanimous Shareholder Agreements
- Stock Option Plans

Warrants

- In VC deals, can be used to bridge valuation gap between Founder and Investor
- A sweetener/ kicker if targets met
- Can be used as incentive to Investor to use its strategic leverage to hasten growth
- Can be useful where investor bridging into subsequent equity round

Management Equity

- Typically a key difference between a PE and VC deal
- Management in PE deal unlikely to carry more than 20%
- Restriction on transfer of shares, except for estate planning purposes
- Requires buy-back provisions

Management Equity

- VC Investor may want stock option plan for management /employees as a form of non-cash compensation to align interests
 - there will be a vesting period within which the options cannot be exercised
 - if employees leave, lose unvested options, out-of-money options and must exercise in-money options
 - options (and underlying stock) not transferable

Down-Road Financing Issues

- VC Deal
 - often provide for next round financing
 - may pre-arrange co-investment upon satisfaction of milestones
- Negotiated terms regarding right of refusal for funding/blocking rights, etc. can be complicated and may have to be unwound on next round financing

Exit Issues

- Exit strategies
 - strategic sale
 - IPO
 - partial sale
 - employee / management buyout
 - retraction rights
- Investor non-compete / non-disclosure

Sample Clauses

[See separate handout]

Questions?

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