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Obtaining Venture Funding and Negotiating Terms in Distressed Markets

In times of economic and market distress and dislocation, obtaining needed funding becomes more important and more difficult, with deal structures and terms (for those fortunate enough to receive funding) favoring new investors. Although venture funds and other well capitalized investors likely will have negotiating leverage, fund-seeking business owners and managers have a variety of techniques and tools at their disposal to protect their interests, leverage their position, and negotiate terms to their advantage.

by Daniel H. Aronson

Venture capitalists seek out businesses run by strong management teams who distinguish themselves from their competition, position themselves to exploit large and growing markets, and adapt, navigate, and execute to build value in good times and bad. Much like the economy and public company investment and trading markets, venture capital is a cyclical business and industry. These cycles have come and gone in the past. They will do so again. The question is simply this: Which business ventures will successfully navigate the obstacles and seize on the opportunities to raise needed capital, and survive and thrive, now and in the future?

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Obtaining venture capital funding is a challenge of the highest order, which only can be overcome by the right combination of company attributes (*e.g.*, management talent, depth and coordination, proprietary products or services, market positioning, sizeable and sustainable growth, and substantial potential return on investment), investor appetite and focus (and the "right fit" with the investor(s), in terms of size of investment, market/industry sweet spot, stage or maturity preference, and value-adds) and timing (in many cases, dictated by a combination of the above plus a fair sprinkling of luck and circumstance). Obviously, obtaining venture funding in times of economic distress and market turmoil makes the challenge all the greater.

The Challenges

Much has been written, spoken, and blogged about all the dysfunction, dislocation, and challenges, particularly concerning economic, credit, employment and market conditions adversely impacting public and private US-based companies. There is more than enough "bad news" to go around, and many experts and commentators believe that an end to the downturn is not yet in sight. These conditions obviously have impacted the venture capital market, as evidenced by a number of fairly well publicized data points:

- Through the first half of 2009 (as compared to 2008), venture financings (both in terms of number of transactions and aggregate dollars invested) were down significantly across all regions, industries, and stages of development.[1]
- Exit and liquidity transactions closed by venture-backed companies (whether through IPOs, which have been nearly non-existent, or sale transactions) are down to near historic lows.[2]
- Early stage financings and "Series A" rounds are down significantly (both in terms of number of transactions and aggregate dollars invested).[3]
- Angel and angel-led investment rounds also are believed to be down substantially (due to steep declines in many angels' personal net worth

and increased conservatism in approaching new private, illiquid investments).

- Venture capital financings that are successfully closing largely have been characterized by (i) long, extended due diligence investigations (both pre- and post- term sheet or letter of intent); (ii) mostly follow-on (*e.g.*, Series B, C and D) investments by existing venture and other investors; (iii) later stage, growth and expansion stage investments in select industries; and (iv) in the early stage space, "best of breed" companies, run by experienced management teams, well positioned in a large, high-growth market, often with a business model and focus that takes advantage of current market dislocations, and/or with a strategic or joint venture partner in place.

The Opportunities

Opportunities for attractive venture capital investments can be found and closed, despite and in some cases because of the difficult economic, credit, and market conditions. To do so, however, requires a thoughtful examination and understanding of what venture capital funds (sometimes also referred to as VCs) are doing (and what influences their investment behavior), as well as a look at what happened following the last substantial venture market dislocation (in 2002, after the burst of the "Internet bubble").

In seeking venture capital funding, it is important for fund-seeking business owners and managers to take the time to understand and consider venture capitalists' needs, perspectives, and objectives. Essentially, there are four principal objectives that influence the approach and behavior of VC investors in the investment transaction process. Whether an expression of initial interest moves to due diligence and a term sheet, or culminates in a successfully closed funding transaction, largely will flow from the VC's consideration and treatment of these four objectives (and its resolution of related issues):

1. Maximizing potential financial returns (ultimately, as measured by return on investment);
2. Protecting the "downside" (or possible loss of investment);
3. Monitoring and influencing the investment's (*i.e.*, portfolio company's) progress, development, and plan achievement; and
4. Pursuing and effecting best available "exit" strategies and liquidity transactions within defined time horizons. The structure and attributes of the VC funding transaction, as embraced in the various and voluminous investment agreements, also largely will be dictated by a VC's efforts to implement and balance these objectives.[4]

What does this mean in the current economic climate and market? First, it is important to understand that venture capital funds operate as fiduciaries and managers of "Funds" (pools of investable capital), where only (albeit a very important) part of their function and duty is to identify, meet the management of, diligence, come to terms with and fund new portfolio companies. VC personnel perform other important functions, and, in distressed times, the urgency and combination of these other functions can occupy most of their time. These include communicating with the Fund's limited partners (*i.e.*, the investors in each fund) and assisting portfolio companies with, among other things, management changes, business repositioning, add-on acquisitions, credit and loan issues and, of course (for those deemed worthy), additional funding and liquidity transactions. With depressed market valuations and limited exit opportunities, VC funds find themselves with mature, later stage portfolio companies that require continuing substantial oversight and capital infusions to reposition, stabilize, and grow (or perhaps to survive).

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So, what are the opportunities for VCs, and how does this affect companies (and entrepreneurs, owners, and managers) seeking venture capital funding? Logic would dictate, and a survey of the post-2001 era of VC investing confirms, that economic distress and market downturns result in lower valuations (including for very good, well positioned companies), lessened competition (as many companies will be distracted or adversely impacted to the point that focus is diminished, growth is not an option and survival is threatened), market dislocation (the flip-side of which is market opportunity) and thus highly attractive investment opportunities. Venture capitalists have long recognized this—some of the best-performing VC funds in history provided substantial capital, as well as business-building, team-building, and market-positioning experience and assistance—during harsh economic times and low valuation environments. Of course, portfolio company managements must be good and agile partners, adapt quickly to change, think "out of the box," and sometimes even reinvent themselves or their business models. When this works, and the economy and markets eventually recover, the portfolio company regains its footing and is well-positioned to grow, perform, exploit opportunities, and pursue exit strategies in a more robust market and at a higher valuation. In times of economic and market distress, the capital raising process should be approached with care and sensitivity and with a recognition that there likely will be stops and (re)starts, disappointments and resets, and that the process will require considerable time, planning, adjustments, and patience.

What Terms are Important? Negotiation Strategies

In challenging and difficult times (including poor economic conditions affecting business models and prospects, and the increased need and competition for investment dollars) deal structures and terms typically become more favorable to new investors. In many cases (when fresh capital must be raised to survive), existing owners are the only ones available to fund the company until the economy recovers and markets move to some semblance of normalcy.

Assistance and counsel from experienced advisors—before structure and terms are agreed on and through documentation, negotiation, and closing—is critical. Venture capital investors are professional and deal-tested negotiators, often assisted by teams of advisors. Although VCs likely will have negotiating leverage (with time working in their favor), fund-seeking business owners and managers have various techniques and tools at their disposal to protect their interests and leverage their position. By working closely with experienced advisors conversant with venture capital transactions and participants, portfolio company founders and insiders can gain an "edge" in navigating the process and negotiating terms to their advantage during challenging times.

While each company's leverage and circumstances will vary, there are some practical realities, contractual protections, and legal considerations that business owners and managers should understand and evaluate in negotiating—to the company's maximum advantage under the circumstances—a venture capital investment transaction. Negotiation strategy, throughout this fluid and dynamic process, should be thoughtfully considered and crafted as well. In this regard, it often is a mistake to fight on every point. The capital-seeking business should consider, based on its own unique position, attributes, and circumstances, the terms it cares (or should care) most strongly about, and be prepared to give ground on other terms. In short, it is important to determine what is most important for the business, existing owners and key personnel and the future, and focus most intently on (the terms that drive) those items. The following probably are the most relevant provisions that will be negotiated, as well as some important process considerations, for a VC investment transaction effected in challenging economies and markets (or in a "down-round" financing[5]).

Valuation. The agreed "pre-money" valuation dictates the percentage of total company equity the new investor(s) will get (and, conversely, the existing owners and managers will be left with) when the investment transaction closes. Valuation certainly is important, and entrepreneurs and business owners should obtain assistance in understanding and arriving at a fair valuation (or valuation methodology). Not infrequently, however, existing owners become fixated on a specific valuation (or value level), and some even "fall on their sword" when new investors do not get all the way there. Remember that, in addition to obtaining funding, entrepreneurs and business owners should seek the right venture capital partner, who can bring tremendous value to the venture and its ultimate success (and also remember that, if needed funding is not obtained, all owner equity may become worthless).

Liquidation preference and "participation" feature. The liquidation preference (of the securities issued to the new investors) is perhaps the most critical economic term in a VC transaction. Put simply, this provision ensures that the new investors get their money back (perhaps, and then some) before other, junior investor-owners receive anything. In addition, VC investors often insist on receiving *participating preferred stock*, which ensures that (in a sale or defined liquidation event) they get both their liquidation preference and then share *pro rata* in whatever funds are available for distribution to common shareholders.[6] In challenging markets and in down rounds (or where investors otherwise have leverage), investors may seek multiple liquidation preferences (*e.g.*, they would be entitled to receive two or three times their investment back before other owners would receive anything).[7] This provision correlates with and affects other provisions, and is worth emphasizing in negotiations. Fight hard to keep the liquidation preference at one times the investment (or, failing that, to provide for circumstances or performance conditions where an agreed multiple liquidation preference would drop to one times the investment).

Anti-dilution provisions. These provisions provide for protection and adjustments in the event the company subsequently raises capital through the issuance of equity securities (or securities convertible into or exercisable for equity securities) at a lower valuation (or at a lower price per share or unit). In challenging markets and in down rounds (and where VC investors have leverage), investors may seek "full ratchet" protection. "Full ratchet" provisions adjust the exercise price or conversion ratio of a security to the lowest price at which securities (including convertible securities, options, and warrants) are issued in the future. Since companies cannot guarantee that future capital raises will be at "up" or "flat" valuations because of current economic and market conditions, proceeding in the face of a "full ratchet" provision could result in substantial voting and economic dilution to previous owners (including management).[8] Companies must be aware of the different types of anti-dilution provisions and their potential consequences. Negotiate hard for broad-based weighted average protection[9] (or, failing that, to provide for a time-based "sunset" provision on the full ratchet and/or other conditions under which the full ratchet provision gives way to a weighted average provision). Appropriate "carve outs" from the operation of anti-dilution provisions also should be considered based on the company's particular circumstances, leverage, capital structure, and plans, *e.g.*, exempting certain potentially dilutive equity issuances to facilitate employee restricted stock and options, warrants in connection with financings and/or acquisitions that meet certain criteria from triggering the anti-dilution provisions. Some companies have been successful in insisting on a "pay-to-play" condition on the anti-dilution protections, *i.e.*, in order for a VC (or other preferred holder) to take advantage of the anti-dilution protections, it must have participated in the dilutive financing round in question at its *pro rata* allocation.

Drag-along rights. VC investors often request (or insist on) so-called *drag-along rights*.[10] Put simply, armed with these rights, if the new investors (or a certain required percentage of them) support a later proposed sale or change-of-control transaction, they can (essentially) force all other owners to go along with it (and to vote or consent in favor of it). This could include a deal (depending on the all-important liquidation preferences) in which those owners who are "dragged along" get little or nothing. Unless the company has real leverage, it is often difficult to eliminate these rights, so (1) negotiate and limit as best you can, and (2) focus on the liquidation preferences (and other important implicated provisions).

Milestone, phased and/or tranche investing. Here, the investor agrees to fund only a portion of the total agreed capital raise (*e.g.*, enough working capital to pursue a sales process or achieve one or more specific objectives that contribute to an increase in valuation) at an initial closing, with the balance funded based on the achievement of agreed milestones or conditions or the lapse of agreed time periods. Tread cautiously here. Defining milestones and conditions, and thus being assured that the investor does not have (or take) an “out” on future commitments, can be difficult, distracting, and time-consuming. Also, valuation (which may be locked in from the outset, even though some funding is being provided after the company matures and tackles important value-enhancing objectives), should be reviewed carefully. These provisions potentially put the company in a vulnerable, disadvantageous position. Negotiate hard for a single closing, and a fully funded round.[11]

Treatment of existing owners. In distressed circumstances (including in down round financings), it is important to treat all owners fairly, to provide full and fair information and to invite and encourage participation by all (not only a good idea, but not doing so may result in claims, lawsuits, and/or liability).[12] Also, because of cram-downs[13] and wash-outs,[14] management and key employee incentives likely will need a fresh look and reset. Keep your owners up to speed, manage their expectations and show them you care about and need and appreciate them (of course, doing so without “empowering” them to raise disputes or prevent or delay can be tricky). Remember that often the best and easiest (and sometimes only) place to raise future funding is from existing owners. In addition, in some cases (depending on negotiated contractual rights), the existing owners may have you *over a barrel* (in more ways than one): they may have the right to block a deal, or may sue if they believe their rights have been breached or that they are not being told the full story. If a litigation results, this can be distracting, expensive, and time-consuming, and may scare off future investors until the matter is fully resolved.

In distressed circumstances (including in down round financings), it is important to treat all owners fairly.

The foregoing is an illustrative list and is not intended to be exhaustive. Depending on a company’s specific attributes, leverage, condition, and circumstances, the creativity and imagination of its counsel, and the willingness and demands of new (including VC) investors, other terms and provisions can be important to negotiate, address and resolve, including board representation, pay-to-play provisions,[15] enhanced rights and protections for participating investors, sunset provisions and performance adjustments, specific representations, warranties and indemnities, unique closing conditions, key employee retention and incentive compensation plans as well as non-competes and other restrictive covenants.

Reality Check before Signing

Venture capital and sophisticated investment transactions can experience many stops and starts, twists and turns, and often end up in a place quite different (and with terms and conditions quite distinct) from where they started (*i.e.*, as embraced in the initial business understanding, term sheet or letter of intent). Business owners and managers, after months of meetings, due diligence, business and market changes and fluctuations and back-and-forth negotiations and drafting sessions, can lose sight of what the objectives, expectations, and limits of the financing were (and are), and whether the investment transaction, as presented in draft and definitive documents prepared for signing and consummation, substantially achieves those objectives and works within appropriate limits and expectations. One reason for this is the amount of time, effort, angst, and expense associated with bringing one’s business to the point of a definitive investment funding agreement (where, in this market, there may be few alternatives to raise needed capital). Notwithstanding this, and particularly when a down-round financing is on the table, it is very important to reflect, weigh, consult, and evaluate whether the transaction, agreement and terms that have finally presented themselves are actually the best thing—on balance and all things and relevant constituencies considered—for the company to proceed with at the time. For some, the answer may be simple: there is no real alternative here; all other potential sources of capital have been exhausted, and without capital now there will be no company and everyone’s investment will be worthless. For others, alternatives (including not closing the round and boot-strapping until, hopefully, economic and/or market conditions improve) may be available.

NOTES

1. PricewaterhouseCoopers and National Venture Capital Association MoneyTree Report (Q2 2009 Results) based on data provided by Thomson Reuters (*www.pwcmonetree.com*) (the Q2 2009 MoneyTree Report); *see also* Dow Jones VentureSource Press Release issued July 1, 2009 ("Despite end of IPO drought, US venture-backed liquidity market hovers at 6-year low").

2. Dow Jones VentureSource Q3 2009 Liquidity Data (*www.venturesource.com*) (reporting that exit and liquidity transactions by venture-backed companies were down 49 percent, from $5.32 billion in 3Q 2008 to $2.70 billion in 3Q 2009).

3. 2009 MoneyTree Report (VC Investments Q2 2009—Charts re: Investment Deals and Dollars by Stage).

4. A more thorough treatment of this subject can be found in the author's book, *Venture Capital: A Practical Guidebook for Business Owners, Managers and Advisors* (Bowne SecuritiesConnect Publications 2007).

5. In a "down-round" financing, a company issues securities (typically, convertible preferred stock or preferred LLC interests) to investors at a value (on a per share or per unit basis) that is less than that paid by previous investor-owners (or in a previous round). This translates into the new investors (i) paying a lower price per share, and (ii) typically receiving certain rights and preferences that are superior to those granted to the previous round's investor-owners. While previous (including initial) investors may have negotiated contractual protections (usually in the form of anti-dilution provisions) when they invested, as a condition to the consummation of most down-round financings, the new investors usually require that existing investors waive such protections. Founders and common stockholders typically have no anti-dilution protections (and thus are adversely impacted both by down-round financings and by new investor anti-dilution protections).

6. "Convertible preferred stock" is the security of choice for VC investors (although, in certain distressed deals and "bridge" rounds, convertible notes have been utilized as well). The security is (i) *convertible* to common stock at the option of the holder under a conversion formula specified in the security instrument, and (ii) *preferred* in that its owners have certain priorities and rights not enjoyed by holders of common stock (including, among others, a liquidation preference). *Liquidation preference* refers to a right to receive a specific value or amount for shares of preferred stock (or equity securities with preferential rights) if the company is liquidated (or deemed to be liquidated) in priority to amounts to be distributed on other (junior or common) securities. A "*participation*" feature entitles the holder to participate (or share) with holders of common stock in dividends and/or liquidation payments, after and in addition to collecting any stated liquidation preference or dividend rights. One way to mitigate the effect of a participation feature is to "cap" the amount investors can collect at some multiple of their investment (*e.g.*, at two or three times the investment amount). According to the Dow Jones Venture Capital Deal Terms Report (2009 Edition) (the 2009 Deal Terms Report), (i) approximately two-thirds of the 200 US companies responding to the survey said they issued participating preferred stock in their latest financing round, and (ii) in more than 40 percent of the financings surveyed, caps on the participation feature were employed (with a cap of two times the most common).

7. According to the 2009 Deal Terms Report, of the 200 US company responses received in the survey, 76.9 percent reported a liquidation preference associated with their latest financing at a one times (1X) return while 6.4 percent reported a liquidation preference greater than a two times return.

8. Venture capitalists are well aware of the importance of management and key employees to the success of a venture (including its management, growth, navigation of challenges, and ultimate pursuit and execution of an exit transaction), and in creating appropriate structures and arrangements to "align interests" and incentivize performance. This awareness is not lessened, and in some ways may be heightened, in the context of successfully closing a funding transaction under distressed conditions (or in a down round).

9. *A full-ratchet* anti-dilution provision is most favorable to VC investors; it provides that the conversion price of the preferred shares is reduced to the price paid in the dilutive issuance, regardless of how many shares are issued in the dilutive issuance. By contrast, *weighted-average* anti-dilution provisions (whether broad-based or narrow-based) provide for more balanced protection, since they take into account the dilutive impact of the issuance in question based on such factors as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after such issuance.

10. According to the 2009 Deal Terms Report, of the 200 US company responses received in the survey, 70.5 percent reported that their financing round included a drag-along right in favor of the investors.

11. There are of course contrarian views (voiced by investors) with respect to staged financings. A staged payment in a first round can be an alternative to having to complete two (full) rounds—better to have management focusing on company development as opposed to fundraising. In addition, some VCs believe that staged financings provide a useful tool in enforcing spending discipline (of course, there are other ways to achieve that end, including an agreed "budget" and spending process). In any event, with the exception of health care and biotech investments (which have important, clearly definable development milestones), and certain first round/early stage investments, staged financings are relatively rare.

12. To this end, a company involved in a *down round* financing (particularly where insiders are involved as investors) should strongly consider a "rights offering" to all existing stockholders (including founders and employees). This would provide them with the right to participate in the financing transaction (typically, at the same price and on the same terms as the VC) and thereby maintain their equity stake and/or minimize dilution. Distressed circumstances can bring significant additional burdens and responsibilities upon the members of the board of directors (or board of managers) of venture-backed enterprises. If a down-round financing is pursued, you can expect existing owners to be unhappy both with the decline in value and the further dilution (and restrictive terms) they may face in the next round. Complaints, claims and litigation may result, including claims of breach of fiduciary duties (in particular, the duty of loyalty) and even fraud (based

on incomplete, inaccurate or misleading information), particularly where venture capitalists and other insiders are on the board or are believed to be exercising influence to their advantage. Accordingly, it is important that board members understand their fiduciary duties (early and often) and take appropriate steps to discharge those duties (and keep a record of same), to minimize the potential for claims and liability and to ensure that there are appropriate protections in place regarding limitation of liability, indemnification and insurance coverage.

13. A *cram-down* refers to a funding transaction, typically in very distressful circumstances and a down round, where the new investors require, as a condition to funding, that all outstanding issues of preferred stock convert into common stock (or junior liquidation preference preferred stock) in order to (i) decrease the aggregate liquidation preference, and (ii) make the realization of a liquidation preference (upon a liquidity event) on the new investors' preferred stock more likely.

14. A *wash-out* refers to a funding round wherein previous investors, founders, and management suffer substantial dilution (and resulting loss of rights, including liquidation preferences) and whereby new investors usually gain majority ownership, control, and superior liquidation preferences.

15. Pay-to-play provisions impose sanctions on investors who do not continue to fund their *pro rata* share of future (down round) equity financings. If the investor does not "play," it suffers specific adverse consequences, including, for example, automatic conversion to common stock or a "shadow" preferred stock, loss of the right to participate in future rounds, loss of anti-dilution protections, loss of veto rights, and/or loss of board representation rights. Pay-to-play provisions are often highly negotiated, and an investor may require that any future financings also contain pay-to-play provisions and also may seek incentives or rewards for participating in future financings (such as a discounted purchase price or more favorable rights and preferences).