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When Venture Funding Is Debt, Not Equity

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Many emerging companies turn to venture debt facilities to meet at least some of their financing needs. Venture debt facilities are typically provided to companies that are still likely to require further equity investments from their venture capital investors. Most of these facilities include a loan facility (term loan and/or a revolver) and a warrant. In today's competitive marketplace, many emerging companies, particularly in the life science, cleantech and consumer tech sectors, need to fund greater up-front capital outlays than in the past for manufacturing facilities, project development, R&D, etc. Equity investors are often hesitant to provide this extra capital; consequently, the demand for venture debt will expand as the need for up-front capital spending by emerging companies grows.

Following are some of the key terms in recent financings provided by venture banks and lenders that should be addressed at the term sheet stage. While this list is not exhaustive and does not address the particular circumstances of a given borrower, it includes issues that borrowers (often without the review of counsel) often fail to raise at the term sheet stage — yet the issues are customarily reflected in the final documentation. To avoid surprises, we recommend that the following terms be negotiated among emerging companies, their counsel and venture credit providers at the term sheet stage.

COMMON LOAN AGREEMENT TERMS

Interest-only period. Three to 12 months is common for interest-only periods. Six months is the most typical interest-only period.

Rate adjustment. Term sheets often indicate that interest rates are set to adjust only on the basis of any "increase" in the underlying reference rate (typically the prime rate or London Interbank offered rate). It is worthwhile to specify that the rate adjusts if there is any change (including a decrease in the reference rate) and whether a floor exists with respect to the rate adjustment.

Default rate. Two to 3 percent was historically the norm for the increase in the interest rate upon an event of default. But 5 percent is now more common. Some venture credit facilities include both a default rate and a late fee, but this is not typical.

Facility term. Two to four years, with three years being the most common, is the typical term for venture term loans (often referred to as "growth loans") and revolving facilities. A one-year term is most typical for venture account receivables facilities, but two- or three-year terms for larger venture A/R facilities are not atypical.

Prepayment fee. During the financial downturn, an increasing number of transactions provided for a 5 percent prepayment premium (paid on outstanding unpaid principal) for the first year, decreasing to 3 percent for the second year and 2 percent the following years. But today, a 3 percent prepayment premium for the first year decreasing to 2 and 1 percent for the subsequent years is more typical, which was the norm pre-financial downturn. Furthermore, recent term sheets do not specify that the prepayment fee only applies to voluntary prepayments; such fees typically do not apply to mandatory prepayments.

Prepayment mechanics. A few venture credit providers have begun insisting on 10 days or more (some 30 days) for notice of prepayment. Two to three business days' prior notice remains the norm as borrowers often cannot foresee when a refinancing will close more than a few days ahead of such closing. Also, many venture credit providers only permit prepayment of the entire loan. If a borrower needs the flexibility to partially prepay (for maintenance of any covenants or to reduce its debt at the request of equity investors, for example) it should discuss such flexibility at the term sheet stage.

Exit/terminal fees. Exit fees (paid at maturity or in connection with a prepayment) of 1 to 3 percent of the loan amount are not uncommon. Venture credit providers often agree to waive such fees if the facility is refinanced with the same lender.

Eligible accounts. For A/R facilities, the borrower should ensure that all accounts that the borrower expects to be included in the borrowing base are in fact included and cannot be arbitrarily removed in the future. Particular attention should be paid to accounts where the account debtor is a foreign entity; venture banks rarely include such accounts in the borrowing base without prior discussion and appropriate diligence.

Banking relationship. Venture banks regularly require that they become the borrower's primary cash management bank. If a borrower currently has accounts with banks other than the relevant venture bank, it is worthwhile to insert a reasonable time frame (30 days, for example) after closing to transfer such accounts and to permit all checks to clear from such accounts.

Performance covenants. Venture credit providers may insist on performance criteria, such as achieving certain regulatory milestones, developing certain products, or obtaining rights to certain intellectual property. However, such performance criteria are often specified to be met at the lender's discretion. If the borrower agrees to these terms, there should be clear, objective criteria for such performance covenants and discretion should be limited.

Collateral. "All assets," first priority liens on collateral have been the norm, with no further detail provided in the term sheets. Borrowers should specify at the term sheet stage any specific carve-outs for IP (for exclusive licenses or specific arrangements or collaborations, for example), specific permitted liens, or permitted secured indebtedness that the borrower requires. Negative pledges on IP (meaning that the borrower will not grant a security interest to others in its IP) remain more common than outright grants of security interests in IP. Some venture lenders, however, require IP security; borrowers should discuss such requirements with their investors and consider the associated costs. Borrowers who own foreign subsidiaries should specify at the term sheet stage that any security interest in such subsidiaries and their assets will not be perfected as the cost of such perfection typically cannot be justified for venture debt transactions. Finally, if a borrower, particularly a cleantech firm, is likely to take advantage of government support or financing during the term of the venture debt, it should discuss at the term sheet stage any carve-outs to the venture credit provider's security interest that may be required to secure such government support/financing.

Outstanding debt. Borrowers should disclose all existing debt at the term sheet stage and confirm that the venture debt will be permitted under such existing debt facilities. If any subordination of the existing debt facility to the new venture debt facility is required, then before signing the term sheet the borrower should confirm that the lender(s) under such existing facility will in fact agree to subordination and under what terms.

Account control agreements. Venture credit providers have on occasion demanded that account control agreements be conditions precedent to closing rather than conditions subsequent. But most venture credit providers still agree that any required

account control agreement may be provided after closing. Borrowers should specify at the term sheet stage whether account control agreements will be required, the time frame for putting such account control agreements in place (20 to 30 days is typical in the venture space) and to which accounts (type and threshold of funds held) such control agreements will apply.

Landlord consents and bailee waivers. Venture credit providers are generally amenable to landlord consents/bailee waivers being put in place after closing. However, it is worthwhile at the term sheet stage to specify whether such consents/waivers will be required, which properties are covered (type of property and/or threshold value of property to be covered) and what time frame will be permitted to put such consents/waivers in place (30 days is typical in the venture space). Most importantly, borrowers should consider specifying the standard for obtaining such consents/waivers — a commercially reasonable efforts standard (meaning the borrower must diligently try to obtain, but does not guarantee that it will obtain) is common as landlords/bailees often refuse to enter into the requested waivers at no fault of the borrower.

Financial Covenants. Venture credit facilities have incorporated financial covenants sparingly; financial covenants are utilized on a case-by-case basis.

No MAC. Borrowers should confirm at the term sheet stage whether a "material adverse change" default will be part of final documentation. If so, borrowers should ensure at the term sheet stage that the MAC term is defined as narrowly as possible and not open to far reaching, subjective interpretation.

Investor abandonment default. Venture lenders and banks frequently require investor abandonment defaults. These permit lenders to declare a default if they believe that the borrower's investors are abandoning the borrower. Borrowers should discuss whether such a default will be included at the term sheet stage. If the borrower agrees to such a provision, it is worthwhile to specify the objective criteria that trigger the default and that such criteria are not open to interpretation at the lender's discretion.

Change in control default. Some venture debt "change in control" provisions incorporate an investor abandonment default as part of such provision (i.e., if a specific investor sells or transfers its interest in the borrower, then a change of control is deemed to have occurred); this is not common as investor abandonment provisions are typically separately documented (please see discussion above).

Change-in-management default. Venture credit providers frequently insist on the ability to declare a default when a "change in management" occurs. The venture bank/lender usually requests that such default be triggered when any key management member departs. If a "change in management" default is included, then at the term sheet stage the parties should specify the positions to which such default would apply and whether a change in all of the top management positions at the same time (CTO, COO, CFO and CEO) is required to trigger this default. Also, typically such defaults do not apply if within a certain period (typically 90 to 120 days) the borrower's board appoints a new person to fill any open management position.

No assignment. Venture credit providers frequently insist on being able to assign their interest in the loans to any entity without notice to the borrower. Borrowers have on occasion limited these assignment provisions so that the venture credit provider (a) must give notice, (b) may only assign, unless an event of default exists, to creditworthy entities and (c) may not assign to competitors of the borrower or to vulture/distressed debt funds. Borrowers should discuss this issue at the term sheet stage, particularly if assignments to competitors of borrower or vulture funds are a concern.

COMMON WARRANT TERMS

Amount of warrant. Venture credit providers typically request warrants equal to 1.5 to 4 percent of the loan amount. The borrower should confirm at the term sheet stage whether the warrant amount is to be based on the amount actually drawn at closing or the entire facility. Borrowers will also want to confirm whether a charter amendment is required to authorize more shares to cover the warrant; if such an amendment is required, a borrower should make sure that its investors are aware of this requirement to avoid surprises.

Exercise price. The exercise price of a warrant is based on the price of the shares underlying the warrant. If it is a common stock warrant, this is typically the most recent fair market value of a borrower's common stock as determined by its board of directors. If it is a preferred stock warrant, it is the series of preferred stock in the most recent financing where preferred stock was sold. Preferred stock warrants are more common than common stock warrants. In any case, the determination of the warrant price should be specified at the term sheet stage.

Warrant expiration. Warrants typically expire 7 to 10 years after the loan transaction is closed, with a seven-year expiration being the most typical.

Anti-dilution provisions. Venture credit providers often request specific anti-dilution protection on a preferred stock warrant. In general, venture credit providers should not receive any more protection than the borrower's other investors. Consequently, venture credit providers will often agree to rely on the protections for preferred stock already provided under the borrower's charter without additional anti-dilution protection.

No impairment clause. Venture credit providers sometimes request a broad, catch-all provision that requires borrowers to protect the warrant holder's rights against impairment. Such a provision is not typical, however, as venture credit providers traditionally agree to rely on the specific, express provisions of the warrant.

Treatment of warrants upon an exit event. Venture credit providers will often request that a warrant be automatically assumed by the acquirer in a sale of the borrower. This is not the market norm as acquirers resist continuing any relationship with the venture credit provider. Consequently, venture credit providers will often agree that upon a sale of the borrower the warrant will be exercisable for cash or publicly traded securities, or a combination of the two. Unlike a sale of the borrower, warrants granted to venture lenders/banks almost always remain outstanding following an initial public offering.

Registration rights. Venture credit providers have historically requested registration rights, though they are rarely used. If provided, such registration rights are customarily structured to "piggyback" on the sale of shares in a public offering or as rights to sell shares in a secondary offering on Form S-3. If the borrower is agreeable to providing such rights, the borrower should confirm that the venture credit provider agrees to be subject to the terms of the borrower's existing registration rights agreements.

Information/notice rights. Venture credit providers often request that information rights be included in the warrant. This is not typical; the warrant is customarily limited to receipt of notice that a major event, such as a stock offering, an IPO or a sale of the borrower, has occurred.

Voting agreements. Borrowers will want to confirm at the term sheet stage that the venture credit provider will agree to become a party to or otherwise be bound by the borrower's existing voting agreement upon exercise of the warrant.

Transfer restrictions and market standoff agreement. Venture credit providers often do not want to limit their ability to sell the shares exercised under a warrant. Venture warrants, however, often include restrictions on transfer (with customary exceptions, such as certain transfers to affiliates) similar to those agreed to by the borrower's other investors and a "market standoff" provision, whereby the venture lender/bank agrees to not sell or transfer its shares for 180 days or longer following an initial public offering. Emerging company borrowers should make sure to be on the same page with the venture bank/lender on transfer restrictions and the "market standoff" provision at the term sheet stage so as to avoid any surprises.

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