

Client Alert

Latham & Watkins
Finance Department

An Overview of Venture Credit Facilities at the Term Sheet Stage

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Many of Latham & Watkins' venture clients, ranging from life science companies to clean tech to consumer tech firms, have been struggling to navigate the current market of available financing options. This struggle will only intensify in 2009. This *Client Alert* highlights some of the key legal terms we have seen in our practice over the last quarter of 2008 in financings provided by venture lenders. This is not an all-inclusive or exhaustive list. It does not address principal business terms such as interest rates, tenor, covenant packages, etc. and in particular does not include a discussion of warrants, which are a component of most venture financing. Furthermore, the following points do not express our opinion or advice with respect to any particular term. Rather, this *Client Alert* highlights some legal terms that have appeared regularly in our recent practice. The mentioned terms are almost always reflected in the final documentation without any or limited discussion at the term sheet stage. To avoid surprises on these issues, we recommend that the following terms be negotiated with venture lenders at the term sheet stage.

Legal Terms

- *Rate Adjustment*: Rates are often set to adjust with any "increase" in the underlying rate. It is worthwhile to specify that the rate adjusts if there is any change (including a decrease in the rate) and whether a floor exists with respect to the rate adjustment.
- *Default Rate*: Two percent used to be the norm for the increase in the interest rate upon an event of default. But for smaller financings 3 to 5 percent is now more common.
- *Prepayment Premium*: Three percent for the first year going down to 2 percent and 1 percent for the subsequent years was typical. Lately, an increasing number of transactions provide for a 5 percent pre-payment premium for the first year going down to 3 percent for the second year and 2 percent the following years. Furthermore, recent term sheets do not specify that the pre-payment fee only applies to voluntary pre-payments; such fees typically do not apply to mandatory pre-payments.

- *Banking relationship:* Venture lenders, when relevant, more regularly request that they become the borrower's primary cash management bank. If the borrower currently has accounts with banks other than the relevant lender, it is worthwhile to insert a reasonable timeframe after closing to transfer such accounts.
- *Performance covenants:* Venture lenders more regularly insist on performance criteria, such as achieving certain 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 intellectual property (for exclusive licenses or specific arrangements or collaborations, for example), specific permitted liens or permitted indebtedness that the borrower requires.
- *Account Control Agreements:* Venture lenders have on occasion demanded that account control agreements be conditions precedent to closing rather than conditions subsequent. But many venture lenders 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 timeframe for putting such account control agreements in place after closing (60 to 90 days is typical) and to which accounts (type and threshold of funds held) such control agreements will apply.
- *Landlord Consents and Bailee Waivers:* Venture lenders 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 timeframe will be permitted to put such consents/waivers in place after closing (60 to 90 days is typical).
- *Financial Covenants:* Venture lenders have incorporated financial covenants sparingly in the current environment; 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 insure at the term sheet stage that the MAC is not broadly defined and open to far reaching interpretation.
- *Investor Abandonment default:* Recently, venture lenders have frequently required investor abandonment defaults which 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-management default:* Venture lenders have more frequently insisted on the ability to declare a default when a "change-in-management" occurs. The venture lender usually requests that such default be triggered when only the CEO departs. If a change-in-

management default is included, then at the term sheet stage, the parties should agree whether only a change in the CEO is required to trigger this default, or 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.

- *No Assignment:* Venture lenders have more frequently insisted on being able to assign their interest in the loans to any entity without notice to the borrower. On occasion, borrowers have successfully limited these assignment provisions so that the venture lender (a) must give notice, (b) may only assign, unless an event of default has occurred and is continuing, to credit worthy 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 a borrower's competitors or vulture funds is a concern.

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