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together

Due Diligence for Venture Capital Financings in the Current Market

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PricewaterhouseCoopers/National Venture Capital Association Money Tree™ Report, Data: Thomson Reuters

Amount Invested Stage of Development	2008 Totals	2009 YTD Total
Startup Seed	\$1,162,290,600	\$718,571,200
Early Stage	\$2,322,028,900	\$706,396,700
Expansion	\$1,709,729,200	\$466,560,500
Later Stage	\$936,489,000	\$205,301,000
GRAND TOTAL	\$6,130,537,700	\$2,096,829,400

SUMMARY

- In the current market, there is an increased emphasis on conducting due diligence as part of the process of negotiating reps and warranties and the financing documents.
- Due diligence now encompasses a more comprehensive review of potential liabilities to assist the investor in negotiating a fair price for the preferred stock, in determining the appropriate valuation and in determining if any third parties' consents are necessary to consummate a transaction.
- As a result, care must be taken to ensure a complete and accurate disclosure in the financing documents.
- There is also increased attention to negotiating the term sheet and financing documents. The results of the due diligence process informs the review and drafting of the financing documents.

TERM SHEET NEGOTIATION AND REVIEW

- Financial Terms
 - Review term sheet to consider prior investor terms versus current investor terms with respect to the following:
 - *Liquidation Preference (amount of preference and seniority of preference)*
 - *Dividends*
 - *Redemption*
 - *Warrants*
 - *Valuation*

TERM SHEET NEGOTIATION AND REVIEW, continued

- Business Terms
 - Review term sheet to consider prior investor terms versus current investor terms with respect to the following:
 - *Corporate Governance*
 - *Shareholder rights*
 - *Side Letter rights*
 - *Approval Rights*

DUE DILIGENCE REVIEW ISSUES

- General provisions
 - Change of control/non-assignability provisions
 - *Review change of control treatment under key agreements which will impact exit valuation.*
 - Check the effective period of the key third party agreements.
 - *Confirm if key agreements may terminate in a short period of time and whether the company may be forced to renegotiate.*
 - Ensure that agreements are properly executed.
 - Identify all consents required (shareholder, lender, lessor, regulatory etc.)

DUE DILIGENCE REVIEW ISSUES, continued

- Option Documents.
 - Review the plan terms to see if vesting will accelerate under any circumstances.
 - Identify and review board and shareholder approvals.
 - *Confirm whether plan and any pool increases been approved.*
 - *Confirm whether the approvals were made timely.*
 - *Confirm whether grants been approved correctly.*
 - Right number
 - ISO/Non-Qual specified
 - Pricing set correctly (fmv or premium for certain insiders)
 - *Review grant documents*
 - *Blue sky filings*
 - *Rule 701*

DUE DILIGENCE REVIEW ISSUES, continued

- Capitalization Table.
 - Reconcile the table with all stock certificates, warrants, option grants, convertible notes, etc.
 - Reconcile the table with board and shareholder approvals.
 - Reconcile the table with charter documents.
 - Reconcile the table with stock purchase/founders' agreements.

DUE DILIGENCE REVIEW ISSUES, continued

- Bylaws.
 - Confirm Board of Directors provisions.
 - Confirm notice provisions are adequate.
- Complaints, answers, other pleadings.
 - Look for evidence of litigation where the company is either plaintiff or defendant

DUE DILIGENCE REVIEW ISSUES, continued

- Employment agreements.
 - Review employment agreements. Confirm whether or not the appropriate people have executed agreements.
 - Review severance arrangements.
 - Review term of employment.
 - Review non-competition provisions
 - Review compensation and benefits terms.
 - Check for deferred compensation arrangements.
 - Check for language that amounts to an option grant.
 - Review offer letters and reconcile against employment agreements if employment agreements were entered into.
 - Check for at-will/for-cause employment language.
 - Confirm whether past employment agreements executed by key employees with previous employers create any issues.

DUE DILIGENCE REVIEW ISSUES, continued

- Founders vesting agreements.
 - Confirm that the stock held by founders is subject to repurchase.
 - Determine how much is left to vest.
 - Determine if vesting will accelerate under any circumstances.
- Proprietary information and invention assignment agreements.
 - Review proprietary information and invention assignment agreements.
 - Review any schedule of intellectual property carved out of such agreements.
 - Review agreements of this type between key employees and past employers.
 - Review non-disclosure agreements executed by employees of the company.
- D&O insurance policies.
 - Review coverage and premiums.

DUE DILIGENCE REVIEW ISSUES, continued

- Material business agreements.
 - Confirm that the company has appropriate agreements in place relating to its core business.
 - Confirm whether the company can document that it owns or has sufficient rights to use its core technology.

FINANCING DOCUMENT REVIEW (STOCK PURCHASE AGREEMENT, REG. RIGHTS AGREEMENT, ETC.)

- Articles/Certificate of Incorporation.
 - Compare to standard venture documents.
 - Review authorized capital structure.
 - Review anti-dilution and conversion features.
 - Identify redemption provisions.
 - Identify board/voting provisions.
 - Review protective provisions.
- Stock Purchase Agreement.
 - Closing conditions.
 - Company representation and warranties.
 - Investor representations and warranties.
 - Subsequent closing requirements.
 - Amendment requirements.
 - Limitations on future issuances.

FINANCING DOCUMENT REVIEW (STOCK PURCHASE AGREEMENT, REG. RIGHTS AGREEMENT, ETC.), continued

- Disclosure Schedule.
 - Confirm pending litigation issues.
 - Employee issues.
 - Customer issues.
 - Financial issues.
- Side Letter.
 - Confirm Board observer terms.
 - Review special terms such as most favored nations.
 - Review other investor rights or exemptions.



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