

Morgan Lewis

together

## Due Diligence for Venture Capital Financings in the Current Market

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Presented at the Bay Area APALSA Conference,  
Opportunities and Challenges in Corporate Law,  
Santa Clara University, January 31, 2010

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

<b>Amount Invested Stage of Development</b>	<b>2008 Totals</b>	<b>2009 YTD Total</b>
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
<b>GRAND TOTAL</b>	<b>\$6,130,537,700</b>	<b>\$2,096,829,400</b>

# 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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