HANDBOOK

STRATEGIC VENTURE CAPITAL INVESTMENTS

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Strategic Venture Capital Investments

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Introduction

Venture Capital typically refers to high-risk private equity investments made by investors in young companies with the potential for significant growth.

Corporate Venture Capital ("CVC") is a term used to describe venture capital investments made by large, established companies, rather than fund investors, which are executed for strategic business reasons as well as for financial returns.

More specifically, a strategic investor often makes a CVC investment as a means to explore a new line of business or enhance its existing business. As a result, a CVC investment is typically coupled with some kind of commercial relationship between the two parties. This may take the form of a joint product development agreement, a collaboration agreement, a services agreement, a license agreement or some other arrangement that provides the strategic investor with access to the target company's technology, products or services.

Although strategic investors commonly co-invest in target companies with financial investors, such as venture capital funds, the interests of strategic and financial investors are not always aligned. A financial investor often manages third party money for a specified duration and therefore seeks timely exits at the highest possible multiple. In contrast, a strategic investor often makes a CVC investment for operational purposes and therefore may place a lower priority on pure investment returns. For example, a strategic investor may want to acquire the target company in the future and therefore is willing to sacrifice financial returns to facilitate such a purchase. A strategic investor may also want to block transactions between the target company and the investor's competitors, even if such transactions would be in the best interests of the company and its other owners.

Subject to certain exceptions, the financial aspects of a CVC investment often are structured like a traditional venture capital investment made by a financial investor. The purpose of this handbook is to describe some of the material terms commonly applicable to all venture capital investments, whether made by financial or strategic investors, and to identify certain other terms more applicable to strategic investors alone.

Overview of Investment Documents[1]

Regardless of whether the investor is approaching the target company from a strategic or financial perspective, there are certain documents and conventions that are standard for a venture capital investment, and the first of these is the stock purchase agreement. This document evidences an investor's acquisition of capital stock in a target company and provides a framework for the transaction. It includes provisions regarding the amount of stock to be acquired and the purchase price, the closing conditions for the purchase (including what documents and information must be delivered by the company to the investor at or prior to closing), and the representations and warranties made by the company and the investor.

Many venture capital investments take the form of a new class of preferred stock, which is typically convertible into common stock upon the occurrence of certain events. The company's charter (i.e., its certificate of incorporation) is amended to describe the terms, rights and privileges associated with the new class of stock. The amended charter will address (1) the liquidation rights and preferences of the preferred stock, (2) the dividends payable in respect of the preferred stock, (3) the voting rights and privileges associated with the preferred stock, (4) the terms on which the preferred stock will convert into common stock, if applicable, and (5) any protective voting provisions or other consent rights associated with the preferred stock.

In many venture capital investments, investors will enter into some combination of an investors' rights agreement, a stockholders' agreement, a voting agreement, a registration rights agreement and a right of first refusal and co-sale agreement. These agreements typically include (1) a right of first refusal and co-sale rights in

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[1]For ease of explanation, this document assumes a strategic investment is made in a target company structured as a corporation. A target company is more likely to be corporation if it has accepted previously, or plans to accept, equity financing from financial investors (e.g., venture capital funds). If a strategic investor participates in the formation and initial financing of the target company without financial investor involvement, the strategic investor may wish to form and invest in a more tax efficient limited liability company.

respect of any sale of stock by the founders, (2) investor preemptive rights with respect to subsequent issuances of securities, (3) "drag-along" rights that permit investors to force a sale of the company, (4) agreements among the stockholders to vote their shares in a prescribed manner, such as for certain director nominees or fundamental transactions, (5) notice and reporting requirements, and (6) registration rights allowing investors to sell shares in a company public offering.

Economic Terms

Valuation

A target company's valuation often is the most negotiated aspect of a venture capital investment. Generally speaking, a strategic or financial investor will seek to maximize its percentage ownership of the company. Conversely, the existing stockholders (including the founders) want to limit the amount of equity surrendered to the new investors. In practice, however, the parties' interest in the company's valuation is more nuanced.

Financial investors are influenced by their own performance metrics and expectations when negotiating a target company valuation, independent of the relative strengths and weaknesses of the company itself. A venture capital fund typically expects a disproportionate amount of its portfolio to underperform. To offset these financial losses, a venture capital fund must invest in opportunities with the potential to return large multiples on invested dollars (e.g., 10X – 30X, or more, depending upon the fund's investment focus and risk profile and the expectations of the fund's investors). Therefore, independent of whether a company's valuation is appropriate or even low, the valuation must theoretically allow the fund to achieve its desired investment multiple.

To calculate the valuation that supports such a multiple, a venture capitalist may forecast the potential exit price of the target company and work backwards. This is called the "Venture Capital Method" of valuation. To calculate the potential exit price, the investor will estimate the target company's annual revenues at exit and apply an industry applicable margin percentage and price-to-earnings ratio. Once this exit price and the investor's investment amount are determined, the investor can calculate the valuation that yields the desired multiple.

A strategic investor may not have the same performance requirements or expectations. Moreover, a strategic investor may view the expenditure of investment dollars as merely the cost of the desired commercial relationship with the target. Accordingly, a strategic investor may place less emphasis on valuation, or at least defer to co-investing financial investors in the negotiation and determination of the investment pricing.

Nevertheless, a strategic investor should ensure the target valuation is appropriate under the circumstances. An excessive valuation can create future financing obstacles for even a solid company with good prospects. A properly priced financing round should leave room for healthy but reasonable valuation jumps in subsequent rounds, which allows the company to manage growth and accommodate the needs of later investors.

Type of Security Purchased

As mentioned above, most venture capital investments take the form of convertible preferred stock. Preferred stock gives the investor certain economic rights and privileges to which the common stockholders are not entitled. For instance, holders of preferred stock typically have priority over the common stockholders with respect to proceeds distributable in an exit event. Preferred stock often is convertible into common stock at the investor's election and automatically upon the occurrence of certain triggering events, such as a public offering, an exit event above a certain price or the approval of a majority-in-interest of the preferred stockholders.

Dividends

Generally, the declaration and payment of dividends, whether in respect of preferred stock or common stock, is in the discretion of the company's board of directors. In some venture capital investments, however, the preferred stock is entitled to a fixed, annual dividend that automatically accrues and cumulates over time. These "cumulative dividends" must be paid in full prior to making any dividends or distributions to the common stockholders. Furthermore, investors may require their cumulative dividends to be paid upon the occurrence of certain triggering events, such as a conversion of the preferred stock into common stock or the exercise of a redemption right.

Liquidation Preference

Preferred stock investments are structured so that, in connection with a company exit event, the preferred stockholders receive a return of their investment (and potentially a premium thereon) prior to any distribution to the common stockholders. This return is called the "liquidation preference."

Liquidation preference rights vary depending upon market conditions and the parties' relative bargaining strength. At the pro-company end of the spectrum, a preferred stockholder may receive the greater of its investment amount and the distributions it would collect if it converted its preferred stock into common stock immediately prior to the exit event. This is known as "non-participating" or "straight" preferred stock.

At the pro-investor end of the spectrum, a preferred stockholder may receive its investment amount (and any accrued and unpaid dividends) plus its *pro rata* share of the distributions made to the common stockholders (as if it had converted its preferred stock into common stock). This is "fully participating" preferred stock.

There are numerous variations on these approaches. For example, the liquidation preference may be based on a multiple of invested capital (e.g., 1.5X) or a specified internal rate of return (e.g., a 15% IRR). Or, the participation feature may be capped at a specific payout amount, after which the preferred stockholders no longer participate in common stock distributions on an as-converted basis.

Anti-dilution Protection

There are two types of dilution that an investor may incur: dilution in the value of its investment and dilution in its percentage ownership of the company. Venture capital investments frequently include mechanisms to minimize both types of dilution.

Investment Value Protection

Although a decrease in the value of an investor's stock is part of the business risk of investing, investors frequently expect some kind of protection against dilution that adversely affects the value of their investment. With respect to convertible preferred stock investments, this protection typically takes the form of an adjustment to the ratio at which the preferred shares convert into common shares. This ratio is expressed as the quotient of the investment price per share over a "conversion price" per share. The initial conversion price per share is the same as the investment price per share, resulting in a 1:1 conversion ratio. If the company issues securities at a price per share that is lower than the investment price per share, however, there is a downward adjustment to the conversion price. Such an adjustment increases the number of common shares issuable upon a conversion, which can mitigate or eliminate the dilution effect.

The two primary forms of value-based anti-dilution protection are "Full Ratchet" and "Weighted Average." Full Ratchet protection provides maximum protection to investors by adjusting the conversion price per share to the price per share at which new securities are issued in the down round of financing. This protection preserves the value of the investor's equity in full. Full Ratchet anti-dilution protection is rare, but investors may negotiate this protection for a limited period of time (e.g., until the first anniversary of the investment date).

Weighted Average anti-dilution protection is more common. The conversion price per share also is reduced in a down round of financing, but not completely to the new issuance price. Instead, the reduction is based on a formula that takes into account the number of shares being issued in relation to the company's total equity capitalization.[2]

Notwithstanding the type of protection agreed upon by the parties, certain equity issuances often are excluded from value-based anti-dilution protection, such as the issuance of options to employees up to a pre-approved “option-pool” percentage, warrants to financial institutions in debt financings and shares issued upon the exercise of existing common stock equivalents. Other exclusions, such as issuances of equity to strategic partners of the target company, may be negotiated.

Percentage Ownership Protection

Investors also may seek protection against a decrease in their percentage ownership of a target company through participation or preemptive rights. These rights give investors the opportunity to purchase their *pro rata* share (based on their existing percentage ownership of the company) of any securities to be sold on the same terms and conditions offered to third parties. These rights enable the investors to preserve their voting power and their ability to appoint directors or receive certain reports (which rights often are contingent upon holding a certain amount of stock).

Founders, existing stockholders, or even lead investors in venture financings may seek to add a “pay to play” feature to the investors’ preemptive rights. This provision imposes penalties on investors who fail to exercise their preemptive rights in full. If an investor does not participate in a subsequent round of financing, its preferred stock may convert automatically into junior preferred stock or common stock at the pre-issuance conversion price.

A typical Weighted Average formula for determining the new conversion price is:

$$NCP = OCP * \frac{OSPI + NSOP}{OSPI + NSAI}$$

NCP = new conversion price
OCP = old conversion price
OSPI = number of outstanding shares immediately prior to the new issuance
NSOP = number of new shares that would have been issued at the old conversion price
NSAI = number of new shares actually issued

The formula assumes that all previously outstanding shares were issued at the old conversion price, and then fixes the new conversion price to the weighted average of the old conversion price and the price at which the new equity is sold.

Governance Provisions

Although strategic and financial investors often hold minority ownership positions in target companies, they will negotiate rights that provide them with access to company management and control over certain fundamental transactions.

Board Participation and Observation Rights

Investors often have the right to designate one or more individuals to serve on the target company's board of directors. Such a right represents one method by which investors can influence or control company actions and operations. Board participation also provides investors with detailed knowledge of the company's business and affairs.

Investors must be mindful, however, of directors' fiduciary duties when bargaining for this right. Such duties may obligate the appointed director to take positions that are inconsistent with the interests of the appointing investors, which could expose the investors and the director to unwanted litigation risk. Investors may mitigate these risks by requiring the company to provide broad indemnification protection funded by directors' and officers' liability insurance.

A strategic investor may face additional issues when appointing directors and as a result forego participation rights altogether. Directors appointed by a strategic investor often encounter more frequent conflicts of interest, especially given the business relationship between the investor and the target company. For example, a strategic investor may want to discourage business engagements between the target company and the investor's competitors, even when those engagements may be profitable for the company. This puts the appointed director in a precarious situation, since he or she must act in the best interests of the company and all its owners. Furthermore, directors appointed by a strategic investor may have access to company or third party information that may not (or should not) be disclosed to the investor, but which the investor may want to see and use.

Given the fiduciary duty and conflict of interest concerns, strategic investors, in particular, may negotiate board observation rights in lieu of board participation rights. With observation rights, investors appoint a representative to participate in board meetings and receive board materials and reports, but the representative is not entitled to vote or otherwise take action as a director. Investors use observation rights to keep themselves informed, to voice their interests and to influence company action, while avoiding fiduciary duty risks. Companies often seek to limit observation rights, however, because the observers are not subject to fiduciary duties. Companies will require observers to be bound by strict confidentiality covenants, and will excuse observers from meetings or withhold information in connection with sensitive matters.

Information Rights

Financial and strategic investors often impose detailed reporting and notice requirements on a target company. For example, target companies often must provide investors with monthly, quarterly and annual financial statements. The investors may have the right to receive and approve the company's annual operating budget and changes to its business plan. Additionally, a company often must inform investors of the occurrence of certain adverse events, such as the default by the company under a material agreement, a material adverse change in the business, or any litigation or governmental proceeding pending or threatened against the company. The investment documentation also may grant inspection rights to the investors, including the right to examine the properties, books and records of the company.

Consent Rights and Protective Covenants

Financial and strategic investors often limit a target company's ability to take certain major actions, especially if those actions could affect the investment position of the investors.

For example, the investment documents may include negative covenants restricting the company from doing the following without investor approval: (1) consummating an exit event; (2) creating and issuing capital stock senior to or *pari passu* with the investor's preferred stock; (3) paying dividends or other distributions in respect of any junior securities; (4) repurchasing outstanding securities other than employee stock upon an employment termination; (5) issuing options other than as contemplated by the company's current stock option plan; and (6) incurring indebtedness.

Investors may impose certain affirmative covenants on the company as well, including an obligation to maintain adequate insurance, obtain nondisclosure, noncompete and invention assignment agreements from its employees, and take adequate or prescribed steps to protect its intellectual property.

Rights of First Refusal

A right of first refusal gives investors the option to acquire the shares to be sold by another stockholder (typically, a founder) to a third party on the terms offered by the third party. In some instances, the first-refusal provisions give the company the *first* right to purchase the shares. If the company exercises this right, the shares are redeemed and cancelled and every stockholder's percentage ownership increases. If the company declines to exercise in full, the investors have a *second* right of refusal.

Certain stock transfers are excluded from a right of first refusal, including transfers to related parties and estate planning vehicles, redemptions by the company and sales after an IPO. Sometimes, transfers to existing stockholders are excluded, but not if such transfers would shift control of the company.

Exit Strategies

Financial investors must have opportunities to monetize their investments. Likewise, there are situations in which strategic investors may need or want to exit their position in a target company. Although a typical investor goal is for the company to go public via an IPO, many exit strategies focus on the ability to sell stock back to the company or to a third party. Redemption rights, co-sale rights and registration rights represent three methods by which investors may seek liquidity.

Redemption Rights

Redemption rights give the investor an option to "put" its preferred shares to the target company after a period of time, or upon the occurrence of certain triggering events, at a pre-determined price. Typically, redemption rights may be exercised on a class basis by holders representing a majority of the preferred shares. The redemption price often equals the original investment amount, but the price may be based on fair market value as well. In some cases, the company may negotiate a corresponding right to "call" the shares after a designated period; typically at least one year after the investor's redemption right may be exercised. An investor likely will require the company to pay a premium price, however, if a call right is granted.

The value of redemption rights as an exit strategy is limited because the company may not have the financial ability to consummate the purchase. Accordingly, redemption provisions typically permit the company to pay the redemption price in installments. Additionally, if the company is unable to redeem the shares, certain redemption provisions permit the investors to take over the company's board, which allows the investors to position the company for an exit event.

Co-Sale Rights and Drag-Along Rights

"Co-sale" or "tag-along" rights give investors the ability to participate in sales of common stock by founders and other significant stockholders on an as-converted basis. Co-sale rights often apply to any sale of common stock regardless of size, but may apply only to situations where a substantial portion of the company's stock will be sold (e.g., at least 50% of the voting power or value of the company).

A stockholder group (e.g., a majority-in-interest of the preferred stockholders or a majority-in-interest of all stockholders) frequently has the right to require other stockholders to join in a sale of the target company to a third party. This is known as a "drag-along" right. A drag-along right often enables investors to sell the company at a time and at a price of their choosing. Separately, for tax, legal, or other reasons, the parties to an exit event may prefer a stock acquisition rather than a purchase of assets or a merger, and a drag-along right enables the stockholder group to implement such a structure without opposition.

Registration Rights

Registration rights enable investors to sell their shares in a public offering by the target company, which gives investors greater access to buyers and potentially better pricing.

There are two types of registration rights: demand registration rights and piggyback registration rights. Demand rights permit investors to require the company to sell their stock in a registered offering. The exercise of a demand right often is subject to a waiting period from the date of investment, usually a term of several years. In many instances, demand rights are exercisable only after the company has an IPO. Investors usually are limited in the number of demand registrations they may request (often one to three). Piggyback rights give investors the ability to participate in primary offerings made by the company and usually are unlimited in number. Registration rights often will terminate after a specified period, such as five years following an IPO.

Registration rights agreements generally permit the offering's underwriters to reduce the number of shares to be registered, which will result in a reduction in the number of shares an investor may sell. Financial investors, particularly in later rounds of financing, pay close attention to the priority of their registration rights and negotiate for no worse than *pro rata* cutbacks that apply equally to all preferred classes.

Target Company Purchases

Overview

Strategic investors often provide value to a target company beyond the mere benefit of their investment dollars. A target company's investment and commercial relationship with a strategic investor gives it credibility in the marketplace. This relationship serves as a reference check for other financial and strategic investors and validates the company's products or services. A strategic investor often provides the target company with introductions or access to potential customers and business partners who can enhance the growth of its business. A target company can leverage a strategic investor's industry knowledge and experience to improve and refine its business model, accelerate the development of its products and services, and avoid costly pitfalls.

In exchange for these contributions, a strategic investor often seeks rights to facilitate its potential acquisition of the company or its assets. This is especially true if the target's assets or products are embedded in or essential to the strategic investor's products or services. A strategic investor wants to discourage third party acquisitions of the assets it uses or wants, especially if that third party is a competitor. Accordingly, these preferred rights often create obstacles for third party buyers and give the strategic investor a privileged position in a sale of the target company.

Despite the numerous advantages of strategic investments to a target company, financial investors and company management recognize that a close relationship between the target company and a strategic investor may have negative consequences. The target company may appear to operate as a "captive" of a strategic investor, and such an appearance could have a chilling effect on the willingness of third party buyers to commit the time and resources necessary to evaluate an acquisition. Moreover, potential third party buyers may worry that a strategic investor will gain access to their confidential or proprietary information during the acquisition process, especially if the strategic investor has board participation or observation rights. This can lead to a depressed market for an exit event and a lower purchase price.

Given this dynamic, these provisions are highly negotiated and customized and may provide varying levels of protection to the parties. The following is a description of some of the protections commonly sought by strategic investors.

Binding Obligations to Purchase and Sell

A strategic investor and a target company may agree in advance to a “spin-in” of the target company or to an automatic purchase and sale of jointly developed products or technology upon the fulfillment of certain milestones. Alternatively, the strategic investor may acquire an option, exercisable in its discretion upon the occurrence of certain triggering events, to acquire the company, the product or the technology. The option may give the strategic investor an exclusive right to buy, or the company may be free to sell to a third party during the option period unless and until the option is exercised. In the latter event, a strategic investor likely would negotiate advance notice requirements of any potential third party sale.

These structures are difficult to implement because the parties must agree on an appropriate future valuation and purchase price. In most circumstances, one party is a winner and the other a loser. If the strategic investor is forced to buy, it may find itself acquiring an unwanted business or paying an excessive purchase price. Conversely, if the strategic investor has an option to buy, it likely will exercise the option only if it is “in the money,” which means the target is selling at a discount to fair market value. And, the existence of the option precludes or discourages any third party acquisition, which further decreases the target’s ability to realize its full value.

Rights of First Refusal

If a target company receives a third party offer to acquire its business or assets, a right of first refusal gives the strategic investor the ability to purchase the business or assets on the offeror’s terms. In other words, after a third party commits the time, effort and resources to evaluate a target and propose a deal, the strategic investor can step into its shoes and consummate the deal. Naturally, first-refusal rights decrease the likelihood of third party transactions. As a result, target companies normally resist these rights, but may grant them when strategic investors have significant bargaining power.

Rights of First Negotiation

Rights of first offer or negotiation require a target company to (1) notify a strategic investor if it has received a third party offer or management intends to sell the company, and (2) give the investor an exclusive period of time to conduct due diligence and propose a deal. The target company is under no obligation to accept an offer from the strategic investor, but it may have an obligation to negotiate in good faith. Although this right is substantially weaker than a first-refusal right, it can still have a substantial chilling effect on potential third party acquisitions.

Right of Notification

A right of notification functions similarly to a right of first negotiation, but it eliminates the strategic investor's exclusive period to pursue a transaction. A target company must notify a strategic investor of its intent to sell the business or its receipt of a third party offer, but the target company will have no further obligation to negotiate with the strategic investor. The notification right, however, still provides the investor with an opportunity to engage in the acquisition process and make an appealing offer that trumps any third party deal. It also ensures the target company is not sold without the strategic investor's knowledge. Target companies are more willing to provide these rights, but may resist if the strategic investor has board participation or observation rights.

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