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# Understanding the Entrepreneur's Mindset

Association of Life Insurance Counsel  
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## Today's Panelists

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- Alexander Cochran, Partner,  
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- Sandi Knox, Counsel, Sidley  
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# Key Drivers and Motivations in Technology Deals

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## For Emerging Companies:

- Access to new markets and distribution channels
- Access to sophisticated operating experience/insights
- High-value logo/third-party validation
- Access to less valuation-sensitive sources of capital
- Potential exit option

## For Corporate Partners:

- Access to new technologies and related data/know-how
- Development of market knowledge
- Adjunct to R&D function
- Attractive addition to partnering arrangement
- Early entry may lead to more significant transactions

# The Technology Company's Mindset

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- Desire to move quickly
- Resistant to bureaucratic processes
- Innovative and disruptive
- High risk tolerance
- Not afraid to fail
- Focused on maximizing exit options (acquisition or IPO/direct listing)
- IP value is core asset

# Large Corporate Values

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- Predictability and control
- Brand and reputation
- Preservation of positive revenue stream and proven business model
- Process and procedures = safety
  - Moving too fast might break things
- Disruption is disruptive to a well-oiled machine
  - Possible distribution channel disruption
  - “Insurance Culture”
- Low risk tolerance

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# Corporate Venture Capital Investment Structures and Terms

# Minority Equity Investment Structures

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- **Preferred Stock Purchase**

- Minority stake in senior or pari passu series of Preferred Stock
- Additional contractual rights (e.g., registration rights, information rights, observer rights, right to designate a director to the Board)

- **Convertible Promissory Notes and SAFEs**

- Promissory note that is convertible (automatically or optionally) into a Qualified Financing
- Conversion at the same price as new money pays or a discounted price
- Often useful for strategic investors who may want to lead an investment round, but don't want to set an enterprise valuation
- SAFE (Simple Agreement for Future Equity) – does away with the “fiction” of debt (think of as prepayment on equity purchase)
- Limited to no downside protection for investor

## Minority Equity Investment Structures – *cont'd.*

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- **Warrant (with or without Promissory Note)**
  - Generally upside “kicker” for commercial relationship
  - Can set performance vesting milestones that align parties’ incentives to drive growth and sync with commercial arrangements
  - Exercise price can be set at an appropriate level that reflects investor’s contributions to enterprise value via a commercial relationship
    - Penny warrant vs. full-value
    - Consider endorsement value of strategic investor as commercial partner



# Key Documents in Preferred Stock Venture Financings

- **Charter (e.g. Certificate/Articles of Incorporation)**

- Capital structure of company is defined and authorized
- Relative rights of different classes and series of stock are established, *e.g.*;
  - Liquidation preference, dividend provisions, antidilution protection
  - Voting rights:
    - Election of Directors
    - Negative Control Rights (sometimes voting control/blocking rights appear in contract in addition to or in lieu of Charter, particularly for strategic investors that may not own enough shares to control a class vote)
    - Waiver by Company of corporate opportunity doctrine (ensure the waiver extends to preferred stockholders and not just directors)
    - Votes Per Share

- **Preferred Stock Purchase Agreement:**

- Company makes representations and warranties about itself (founders sometimes will be asked to stand behind the reps, too).
  - “Compliance” rep speaks as of the present; consider expansion to cover past periods and specific relevant issues
  - IP representations particularly important
- If participating in a subsequent closing, consider requesting that reps/warranties/disclosure schedule be brought current
- Indemnity is highly unusual



# Key Documents in Venture Financings

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- **Investors' Rights Agreement:** Registration rights, information rights, right of participation in future financings, additional protective provisions for investors, confidentiality provisions
  - Include “Right to Conduct Activities” provision, and exclude CVC from definition of “Competitor”
  - Hard-wire in CVC as “Major Investor” to retain information rights and observer rights as long as any shares are held (or can be covered in the Side Letter). Failing that, identify and protect any sacred rights
  - Reputational put right (or can be covered in the Side Letter)
  - Acknowledgment that investors that may have regulatory reporting requirements that supersede contractual confidentiality requirements (or can be covered in the Side Letter)
  - Depending on stake, consider covenants re: control/compliance environments
- **Right of First Refusal and Co-Sale Agreement:** Keeps entrepreneurs (founders and key employees) locked in as stockholders by requiring that investors get to participate in an “exit” or disposition of founder shares
  - This is often being negotiated by founders to provide a liquidity path for them ahead of investors (which is contrary to the original purpose of the agreement)
  - Exclude reputational put right from ROFR/Co-Sale restrictions if the ROFR/Co-Sale obligations also attach to Preferred Stock (rare)

# Key Documents in Venture Financing

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- **Voting Agreement:** Determines which holders control designation of directors; also “drag-along” that requires signatories to vote in favor of transaction approved by a majority of the common and/or preferred stock
  - Include “optional” drag-along exceptions of “no restrictive covenants” and “no amendment/termination/extension of commercial agreements required”
  - Include conditions on provisions for indemnity treatments

*Industry has coalesced around National Venture Capital Association forms as starting point*

- **Side Letter**

- Extension of Major Investor status to extend information rights and observer rights for so long as the investor holds any shares of the Company (or can include in the IRA)
- “Use of Name/No Publicity” provisions
- “Most Favored Nations” provisions
- Change of Control right
- Bespoke provisions

- **Board Observer Rights Letter**

- Disclaim fiduciary obligations
- Tailor Company rights to exclude observer

# RONs, ROFNs, Calls, ROFRs, Options to Buy – to be requested with extreme caution

Right of Notice	Right of Negotiation	Call Option	Right of First Refusal	Option to Buy (Structured Acquisition)
<ul style="list-style-type: none"> <li>Notification of inbound offer or initiation of sale process (retention of bankers)</li> <li>Identity of offeror may or may not have to be disclosed</li> <li>Terms may or may not have to be disclosed</li> </ul>	<ul style="list-style-type: none"> <li>Right of Notice, plus</li> <li>Standstill period during which target company cannot enter into exclusive talks with an offeror without giving rightholder opportunity to submit a competing offer</li> <li>Rightholder's offer must be considered in good faith</li> <li>In some cases, rightholder can force negotiation</li> </ul>	<ul style="list-style-type: none"> <li>Right to buy other holders' shares upon certain triggering events</li> <li>Sometimes matched to put rights of other shareholders</li> </ul>	<ul style="list-style-type: none"> <li>Right of Notice plus</li> <li>Right to match/preempt another offer</li> </ul>	<ul style="list-style-type: none"> <li>Fully-negotiated purchase agreement</li> <li>Typically coupled with up-front minority investment or commercial partnership</li> <li>Includes firm valuation/purchase price in advance</li> <li>Option criteria clearly defined</li> <li>Board and shareholder approval obtained</li> </ul>

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# Venture Capital Diligence vs. M&A Diligence

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Goal in both transactions: disclosure, but difference in post-closing relationship means difference in depth of diligence

## Venture Post-Closing Relationship:

1. Minority ownership (often sub-10% of fully diluted capitalization)
2. Company management/employees and investors share in upside and downside
3. Discovered risks can be compensated for via:
  - Pre-closing: valuation reductions
  - Post-closing: lawsuits (mostly theoretical unless fraud); subsequent down-rounds

## M&A:

1. Complete ownership (keys are handed over); behaviors of target imputed to buyer
2. Risks can be compensated for via:
  - Pre-closing – purchase price reductions
  - Post-closing – escrow claims, R&W insurance claims

# Venture Diligence vs. M&A Diligence (Legal)

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- **Venture Diligence**

- IP ownership
- IP infringement
- Pro forma cap table
- Material contracts review
- Compliance Issues, *e.g.*:
  - Employment
  - Privacy and data security
  - Trade and export laws
  - Anticorruption law
- Background and reference checks; integrity issues

- **M&A Diligence**

- All items listed to the left, in much greater depth, plus:
  - Tax compliance
  - 280G golden parachute analyses
  - Employment arrangements
  - Detailed contract review (assignment and termination provisions)

# What To Look For in Venture Due Diligence: Legal Issues That Can Materially Impair Valuation

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- **IP ownership**
  - Lack of robust PIAs signed by present and past employees and contractors
  - University licenses
  - Government funding
  - “Levandowski” problems (trade secret theft)
- **Material contracts limiting issuer’s ability to grow**
  - Exclusivity/Options/MFNs
  - Noncompetes
- **Equity ownership challenges/special rights**
  - Any Winklevoss Twins or “Fifth Beatle” problems?
  - Special preemptive rights?
- **Employment practices**
  - Employee/contractor misclassifications
  - Exempt/nonexempt employee misclassifications
- **Litigation/Compliance with laws**
  - “Me Too” Issues
  - Tone at the Top



# Venture Diligence: Process and Timing

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- **Who:**

- Identify who is reviewing what
- Be mindful of IP contamination possibilities
  - Outside diligence reviewers needed?
  - Clean room processes needed?
- Identify and train internal clean team to make risk judgments about legal diligence issues that arise.

- **Timing:** Request list goes out to issuer as soon as term sheet in hand

- **Focus:** Request voiceover call with company counsel at the outset to build risk topography (so you know where to dig)

- **Refine:** Let company's draft disclosure schedules against flat reps be your guide

- Leave time before closing for supplemental questions
- Means need to push for these sooner rather than later

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# Current Issues in Corporate Venture Capital

# Current Economic Climate Defined by Fear, Uncertainty and Doubt

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- COVID-19: Economic fallout varies by sector, but technology overall continues strong performance
- US-China trade wars
- 2020 Presidential election
- Capital markets and corporate debt market – which way are they headed? More or less capital available?



# What do investors and entrepreneurs do in uncertain times?

	Traditional VC	Corporate VC	Entrepreneurs
<b>Hunker down</b>	<ul style="list-style-type: none"> <li>Funds slow pace of investments to keep powder dry for most promising companies</li> </ul>	<ul style="list-style-type: none"> <li>Parent may slow capital expenditures</li> <li>CVC budget set-asides may be reduced</li> </ul>	<ul style="list-style-type: none"> <li>Do more with less (as per usual)</li> <li>Pare back staff and budgets</li> </ul>
<b>Seek value</b>	<ul style="list-style-type: none"> <li>Require lower enterprise valuations</li> <li>Drive more stringent go/no-go decision making to sharpen portfolio focus</li> </ul>	<ul style="list-style-type: none"> <li>Seek innovations through commercial partnerships</li> <li>Require higher ROI in alternatives to preferred stock</li> <li>Buy companies entirely to take advantage of depressed valuations</li> </ul>	<ul style="list-style-type: none"> <li>Avoid setting valuation in declining market</li> <li>Create reliable revenue streams by entering into partnerships with mature companies</li> <li>Seek other nondilutive financing (loans, grants)</li> </ul>
<b>Seek certainty and stability to weather the storm</b>	<ul style="list-style-type: none"> <li>Pay-to-play and price-correction mechanisms may return</li> </ul>	<ul style="list-style-type: none"> <li>Focus may return to core business and away from innovation</li> </ul>	<ul style="list-style-type: none"> <li>Drive revenue</li> <li>Seek inexpensive financing</li> </ul>

Bottom line: Downturn may create valuable opportunities for CVC, provided investors can exercise discipline and identify winners.