

# Negotiating with investors

**Advanced Starter Seminars**

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# Who / What / Why?

- ▶ Mike Truyen; former lawyer at Eubelius; CLO at Mithra Pharmaceuticals (Euronext: MITRA); currently CLO at Xior Student Housing (Euronext: XIOR)
- ▶ Negotiating agreements with investors, from a legal perspective
- ▶ A flavor of the issues involved, potential pitfalls and opportunities

# But first

**Warning: This presentation has been known to cause, amongst others:**

- **Headaches**
- **General Confusion**
- **Increased use of jargon**
- **Increased risk of developing understanding and even sympathy for lawyers**

Luckily, most of these effects have been shown to be transient.

# Agenda

1. Parties / Constituencies
2. Shareholdings and valuation
3. “Valuation gaps” (and how to bridge them)
4. Classes of shares
5. Exit preference
6. Anti-dilution protection
7. Incentive schemes
8. Milestones
9. Shareholders Agreements
10. Subsequent rounds
11. Exit - IPO
12. Liquidation - Bankruptcy

# 1. Constituencies

- ▶ Typical case for a VC-backed spin-off:
  - ▶ **3 constituencies** with interests that are aligned/divergent depending on the issues at hand:
    - ▶ IP provider (knowledge institution; TechTransfer Office; corporate)
    - ▶ Founders (scientists/professional managers)
    - ▶ Financial investors:
      - ▶ Venture Capital funds (“VCs”)
      - ▶ Business angels
- ▶ Idea, “sweat&brains”, money

# 1. Constituencies (2)

- ▶ Changing coalitions among constituencies:
  - ▶ Technology transfer
  - ▶ Shareholder rights
  - ▶ Management package

# 1. Constituencies (3)

## Money is money, right?

- ▶ 4 general types of financial investors:
  - ▶ 1. Venture Capital funds
    - ▶ General partner - limited partners
    - ▶ Motivations - investment horizon
    - ▶ Types of VC funds
    - ▶ Criteria for selecting a VC (follow-on investments, expertise in the field, quality of support to be expected, access to network)
  - ▶ 2. Seed funds
    - ▶ Specific type of fund
    - ▶ Specific investment focus and investment rules
    - ▶ Limited potential for follow-on investments

# 1. Constituencies (4)

- ▶ 3. Business Angels
  - ▶ Typically less able to provide follow-on investment (possibility for conflicts down the road)
  - ▶ Tend to be personally involved
  - ▶ Criteria for selection even more important (personal experience/expertise, network)
- ▶ 4. FFF



## 2. Shareholdings and valuation

Valuation: science or black art?

- ▶ Pre-money valuation, post-money valuation:
  - ▶ 2 sides of the same coin
  - ▶ Usually more of a “compromise” and less of a “valuation”
  - ▶ Pre-money valuation = the valuation of the Company as assessed by new investors, immediately prior to their investment
    - ▶ When divided by the number of shares in existence, this comes to a price per share
    - ▶ That price per share is what the investors are willing to pay for a new share

## 2. Shareholdings and valuation (2)

- ▶ Post-money valuation = the valuation of the Company immediately after the investment by the financial investors
  - ▶ = pre-money valuation + amount of the investment
  - ▶ When divided by the number of shares outstanding after the investment, this comes to the price that the financial investors paid per share
- ▶ Valuation “step-ups” between consecutive financing rounds are therefore largely “paper money”
  - ▶ For example, if the Series A price per share was EUR 1.00, and the Series B price per share is EUR 1.50, this means that the perceived value of the entire Company (and of every single existing share) has increased by 50%

## 2. Shareholdings and valuation (3)

- ▶ “Value of valuations” depends on how rigorously that price was negotiated (e.g., in case of an internal round, no real incentive to heavily negotiate => paper step-up)
- ▶ Proof of the pudding remains in the eating: Exit, IPO, ...
- ▶ ! can be a hindrance in case of “down” / “distress” round
- ▶ The “price per share” and the valuation attributed to the contribution made by each constituency, determine the shareholding structure, which influences:
  - ▶ Voting rights
  - ▶ Entitlement to Exit proceeds
  - ▶ Dividend rights

## 2. Shareholdings and valuation (4)

- ▶ Principle: each share has same rights, although the new Belgian Company Code allows that principle to be left behind/modulated much more (e.g. loyalty shares)
- ▶ But: each of these matters is typically heavily modified in the contractual provisions governing the investment, and that trend looks likely to increase under the new Company Code
- ▶ Therefore: do not over-estimate the importance of valuations

### 3. “Valuation gaps” - bridging

- ▶ Discussions on valuation of IP can become a numbers game (we think it's X Mio, they think it's only Y Mio, given the risks involved in further scientific work)
- ▶ However, note that:
  - ▶ This “number” is only a means to an end: determine the rights of the IP provider relative to those of the financial investors
  - ▶ While this must be fixed when the contribution of IP is made, it is not cast in stone:

### 3. “Valuation gaps” – bridging (2)

- ▶ License => royalties / milestone payments (reward success)
  - ▶ Actual contribution into the capital only after some de-risking event?
  - ▶ Provide incentives in the form of extra equity upon de-risking?
  - ▶ Craft Exit preferences in such a manner that, upon success (of the Company, and therefore the Technology), the original end-result aimed for by the IP provider is achieved
  - ▶ ! However, lack of success of the company does not always mean a lack of success of the Technology
- ▶ Perennial debate: does an “IP euro” equal a “cash euro”?
- ▶ Danger of this question: if the answer is no, the answer will remain no even after the value of the Technology has been demonstrated

### 3. “Valuation gaps” - bridging (3)

Legal forms of technology transfer:

- ▶ Sale
- ▶ License
- ▶ Contribution of ownership (“sale” of IP in consideration for shares)
- ▶ Contribution in enjoyment
  - ▶ Contribution of right to use IP (“license” in consideration for shares)
  - ▶ Unlike license, cannot be terminated
- ▶ Mixed contribution in enjoyment/license (“equity component”)
- ▶ Warrant (on top of license) (“equity kicker”)

### 3. “Valuation gaps” - bridging (4)

- ▶ Any of these forms of technology transfer can be combined with any of the other forms, and it is not unusual that the nature of the rights of the spin-off on the IP evolves during the life of the spin-off
- ▶ = balancing act between freedom-to-operate (FTO) of the spin-off, concerns of IP providers, demands from financial investors



## 4. Classes of shares

- ▶ Typical distinction:
  - ▶ Preferred Shares (offering various types of preferences, typically at least some form of Exit preference)
  - ▶ Common Shares (offering no preferences, and therefore, by virtue of the principle of “communicating vessels”, bearing the burden (= paying for) the preferences enjoyed by the preferred shares)
  - ▶ Where do IP shares fit in?
    - ▶ Sometimes Common Shares, sometimes same type of Preferred Shares as the financial investors, sometimes a separate class of shares “in between” both
- ▶ Preferences thwart the valuation given to contributions and the relative shareholdings stemming therefrom

## 4. Classes of shares (2)

- ▶ A range of other rights and obligations are typically linked to “classes of shares” as well
  - ▶ Transfer restrictions
  - ▶ Rights to propose/appoint Board members
  - ▶ Vetoes and super-majorities (under new Company Code even multiple voting)
  - ▶ Information rights
- ▶ New financing rounds typically mean that a separate, new preferred class of shares comes “on top of” the existing structure (diminishing not only the preferred nature of the existing preferred shares, but further “worsening” the situation of the common shares)

# 5. Exit preferences

## How to distribute Exit proceeds - “dividing the cookie jar”

- ▶ Exit preference = specific entitlement to portion of Exit proceeds of a certain class of shares
- ▶ Typical components
  - ▶ “Multiple” (1x, 2x, 3x investment)
  - ▶ IRR (internal rate of return)
  - ▶ Catch-up? Full or only 1x? None (“double dip”)?

## 5. Exit preferences (2)

- ▶ Typical VC way of looking at this:
  - ▶ New money > older money > IP > Management/Founders
- ▶ Exit preference can be structured in many different ways, but principle, and intended end result is identical:
  - ▶ Convertible classes of shares (choice or “best of both” (i.e. double dip)).
  - ▶ Exit preference attached to classes of shares in Articles
  - ▶ Cumulative (accruing) preferred dividends attached to shares => important to recognize (dividends are often seen as “unrealistic” in spin-offs, but this can allow an “Exit preference” to sneak in below the radar)

# 5. Exit preferences (3)

- ▶ Ultimate goal =
  - ▶ “Bad” scenario
    - ▶ Not enough money to repay every VC share (1x)
    - ▶ VCs will receive the exit proceeds (as they present themselves at that time)
    - ▶ Penalizes Management (and IP provider) for failure

## 5. Exit preferences (4)

- ▶ “Moderate” scenario
  - ▶ Make sure VCs at least meet their internal goals for “success” of a project, prior to allowing Management and IP provider to cash in
  - ▶ Multiple or IRR
  - ▶ Sets a “hurdle” which will define a successful Exit))

# 5. Exit preferences (5)

- ▶ “Success” scenario
  - ▶ Ideally (from the point of view of Management/IP provider), the Exit preference then becomes irrelevant (as the VCs are given at least their “success” rate of return, so that the motivation for the different treatment falls away)
  - ▶ Catch-up or no Exit preferences anymore.
  - ▶ However, in practice, this tends to be a negotiation point (“double dip”, *i.e.*, enduring preferential treatment of “cash shares” even after the point where the threshold is crossed)

# 6. Anti-dilution Protection

- ▶ Principle:
  - ▶ Protection for financial investors against (financial) dilution due to an issuance of shares below the price paid by such financial investors
- ▶ Mechanism:
  - ▶ Issue more shares to protected investor free of charge
- ▶ True effect:
  - ▶ “Corporate nuclear bomb”, not actually meant to be used (new investors simply adapt price per share at a given pre-money valuation)
  - ▶ Creates veto right against down round without approval (in the form of waiver of the right to exercise the anti-dilution protection)



## 6. Anti-dilution Protection (2)

- ▶ Possible forms:
  - ▶ Convertible classes of shares (adapt conversion ratio)
  - ▶ Anti-dilution Warrants (Warrant for the issue, free of charge, of additional shares)
  - ▶ Contractual call options among shareholders
- ▶ Calculation methods (more or less severe):
  - ▶ Full ratchet anti-dilution
    - ▶ Solely price-based

## 6. Anti-dilution Protection (3)

- ▶ Weighted average anti-dilution
  - ▶ Determined by the price of the new round, and weighted by the size of the new round vs. the number of outstanding shares)
    - ▶ Narrow-based weighted average (non-diluted)
    - ▶ Broad-based weighted average (fully diluted)
- ▶ Potential corrective mechanisms
  - ▶ Pay-to-Play (incentive to participate)
  - ▶ Tapers
  - ▶ Internal Round exemption
- ▶ Important: this “protection” (and its corrective mechanisms) can influence “down”/”distress” round discussions

# 7. Incentive schemes

- ▶ How to reward Founders, Management, employees
- ▶ Heavily tax-driven (tax consequences / tax risks)
- ▶ Possibilities (with a corporate component):
  - ▶ Grant of stock options (special Belgian tax regime)
  - ▶ Subscribe for “cheap stock/Founder Shares” (sweat equity/sweet equity)
  - ▶ Grant of “profit certificates” (non-capital representative shares)

## 8. Milestones

A number of important events can be hinged upon “milestones”:

- ▶ Further capital calls (staggered investment / tranching)
  - ▶ Conditionally paying up capital that has already been issued
    - ▶ Statutory minimum to be paid up immediately
    - ▶ Further calls: in principle at discretion of Board; term is valid but conditions are not valid
  - ▶ Mandatorily exercisable warrant
  - ▶ Contractual commitment / voting arrangement

## 8. Milestones (2)

- ▶ Re-adjustment of valuation (“bridging the valuation gap”)
  - ▶ Cf. mechanisms of tech transfer
  - ▶ Mechanisms that adjust cap table to the benefit of IP provider (more success) or VCs (less success)
  - ▶ Automatically convertible classes
  - ▶ Warrants triggered by reaching (resp. not reaching) Milestones
  - ▶ Contractual call option mechanism

## 8. Milestones (3)

- ▶ Vesting of stock options/sweet equity
- ▶ “Pull the plug” scenarios for the spin-off: voting agreement to liquidate

## 9. Shareholders Agreements

- ▶ Agreement among shareholders to regulate voting, exercise of rights vis-à-vis Company and other shareholders, etc.
- ▶ Subscription Agreement: Representations and Warranties (Company/Founders/Management) => potential liability
  - ▶ Assure financial investors that “everything” is disclosed
  - ▶ Data Room/Q&A
  - ▶ Broad spectrum, from benign to very harsh
  - ▶ Usually some personal exposure (incentive to disclose)

# 9. Shareholders Agreements <sup>(2)</sup>

- ▶ Transfer restrictions:
  - ▶ Lock-up
  - ▶ Pre-emption Right (“Right of First Refusal”)
  - ▶ Tag Along
  - ▶ Drag Along
  - ▶ Exemptions (important)



## 9. Shareholders Agreements <sup>(3)</sup>

- ▶ Director proposal rights (no direct appointment possible)
- ▶ Supermajorities (decisions at Board level and by shareholders meeting)
  - ▶ For matters of prime importance
  - ▶ Vetoes
  - ▶ Avoid deadlock
- ▶ Exit Preference

# 9. Shareholders Agreements <sup>(4)</sup>

- ▶ Stock options (reserved warrant pool)
- ▶ Protective covenants:
  - ▶ IP protection
    - ▶ Confidentiality
    - ▶ Non-compete
    - ▶ Assignment of inventions

# 10. Subsequent capital rounds

- ▶ “The 3 constituencies” again, but with twists:
  - ▶ Founders/Management/scientists (people may have left/under/overperformed)
  - ▶ IP provider (improvements? Other applications?)
  - ▶ Financials (existing vs. new?)
- ▶ “Layering” of preferences, valuation step-up (?)
- ▶ Anti-dilution protection
  - ▶ Effect in case of down round: disastrous
  - ▶ Corporate WMDs
- ▶ In case down round needed:
  - ▶ Numerous possibilities for parties to impede can come from “innocuous looking” provisions
  - ▶ Division “believers”/“non-believers”: incentive to “punish” non-believers can impede finding a solution, so if at all possible best to regulate up front (but “planning for failure” is not popular...)

# 10. Subsequent capital rounds (2)

- ▶ Prior agreements (existing Shareholders Agreement, Articles of Association, etc.) can try to provide for this (and usually do) but, in the end, in many cases, “all bets are off”
  - ▶ Depends on strength of bargaining position of the Company *vis-à-vis* new investors (attractiveness of the project, progress made, expected milestones vs. how critical the need for further financing is)
  - ▶ Existing agreements are not irrelevant, however (serve as “floor”, set expectations, can determine bargaining power between existing parties)

# 11. Exit - IPO

- ▶ “Exit” =
  - ▶ Liquidation
  - ▶ Share deal (acquirer - shareholders)
    - ▶ Trade Sale
    - ▶ Buy-out
    - ▶ Secondary transaction

# 11. Exit - IPO (2)

- ▶ Asset deal (acquirer - Company)
- ▶ Corporate restructuring (acquirer - Company)
  - ▶ Merger, de-merger
  - ▶ “Company-building merger”
  - ▶ True exit
- ▶ IPO?

# 11. Exit - IPO (3)

- ▶ Share Purchase Agreement:
  - ▶ Representations & Warranties (again):
    - ▶ Price adjustment
    - ▶ Escrow / partially deferred payment?
    - ▶ R&W insurance?
  - ▶ Earn-out?
  - ▶ Usually triggers incentive schemes (vesting of warrants etc.)
  - ▶ Inter-Seller Arrangements

# 11. Exit - IPO (4)

## IPO:

- ▶ “Going public” => selling shares to the public and listing on a stock exchange
  - ▶ Typically primary (not secondary) offering (therefore, not truly an “Exit”)
  - ▶ Greenshoe mechanism (“issue more shares”/overallocate/stabilize)
  - ▶ Due diligence
  - ▶ Prospectus (with prospectus liability)
- ▶ Afterwards: listed company (different level of requirements)
- ▶ FSMA oversees listing and requirements for listed companies



# 12. Liquidation - Bankruptcy

## ► Bankruptcy

- Failure to meet current due debt
- Inability to obtain further funding (“shocked credit”)
- Possibly, “suspicious period”
- Can IP provider take contributed asset away from creditors or at least get it back in kind by preference over other shareholders?
- Potential liabilities and even criminal sanctions
  - ⇒ Board and management need to be aware of this possibility in “run-up” to funding (“business judgment rule”: reasonable director in same position; *ex ante*)

# 12. Liquidation - Bankruptcy (2)

## ► Liquidation

- Following decision to wind up the Company
- Solvent or insolvent liquidation
- Insolvent liquidation may still lead to bankruptcy
- Can IP provider take contributed asset away from creditors or at least get it back in kind by preference over other shareholders?

Thanks for the attention

