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STARTUP & ACCELERATE

Corporate Venture Capital Trends

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E. John Park, Matthew H. Lewis

Presenters



E. John Park



Matthew H. Lewis

Morgan Lewis

Overview: Current Trend

- Corporate Venture Capital investment continued to be strong through the second quarter of 2022 with some impacts from COVID and inflation concerns.
 - Most deals were \$10-25M in 2022
 - CVCs currently constitute more than 30% of venture deals.

Overview

- How and when does a CVC typically enter an investment?
 - CVCs as lead
 - Usually for strategic alignment that is tightly linked between the investment company's operations and the startup company.
 - VCs as lead
 - Having a VC co-investor can help mitigate conflict of interest issues (i.e., separate the investment decision from the decision to enter into a business/vendor relationship)
 - Up rounds/down rounds
 - **MLB CVC Survey for 2022**—almost all of the transactions we reviewed involved a higher valuation than previous rounds. Four flat rounds and one down round were observed.

Overview – Stages of a Financing

- I. Term sheet for Investment
- II. Diligence
- III. Capitalization Table (current and pro forma)
- IV. Financing Documents, Side Letter and any Strategic Commercial Agreement



Negotiating Deal Terms – Basics

- Things to consider when negotiating deal terms:
 - Any prior rounds or investments (equity, convertible debt or other form of investment) with other VC/sophisticated investors?
 - Warrants? If provided, companies will often couple warrants with milestone conditions and exercise limitations so that the equity kicker is tied to tangible benefits for the company.
 - Be mindful of NDAs: strategic investors may now or in the future be actively competing with the issuer.
- **[Best Practice]:** Critical to articulate and communicate mission internally and externally
 - strategic and/or financial goals
 - deal flow, filter and decision-making processes
 - impact on agreements with business unit
 - terms for business unit may impact financial performance of company, consider conflicts of interest
 - important to manage internal constituencies that may feel threatened
 - e.g., internal teams that may be trying to solve same problem as portfolio company

Deal Stage I. Investment Term Sheet

- **Economic Terms:**

- Valuation, Dividends, Conversion, Anti-Dilution, Liquidation preference

- **Control Terms:**

- Board seat or observer
- Participation rights and Pay to Play
- Protective provisions
- ROFR and Co-Sale Right
- Management/employee retention and incentives

- **Exit Terms:**

- Co-Sale Right
- Drag Right
- Redemption rights
- Registration rights



Economic Terms: Valuation, Dividends, Conversion, Anti-dilution

- **Valuation:** pre-money valuation / fully-diluted # of shares = share price
 - Includes various components of valuation (i.e., how existing debt or convertible securities convert into round, size of option pool, other fully-diluted considerations, etc.)
 - **[Best Practice]:** Have company counsel confirm the cap table at an early stage to avoid any surprises regarding company's definition of "fully-diluted"
 - **MLB 2022 CVC Survey:** Almost all of the transactions involved higher valuation than previous rounds; may indicate the strong desire of CVC programs to invest in companies with a clear growth trajectory
- **Dividends:** "when and if declared by the Board"
 - cumulative (RARE) vs. non-cumulative
 - **MLB 2022 CVC Survey:** Only 5.88 % of the transactions included cumulative dividends, a slight increase from 5% from Q1
 - pari passu with common stock or priority
- **Conversion:** convertible into Common
 - At individual election
 - Mandatory at election of specified percentage (key for recapitalizations)
 - Mandatory on Qualified Public Offering (provide size and price requirements)
- **Anti-dilution protection** for a below-investment share price in future financings
 - Typically weighted average

Economic Terms:

Liquidation preference

- Priority on liquidation ahead of Common Stock
 - Series B > Series A > Common Stock
 - Series A and Series B together > Common Stock
 - Liquidation includes acquisitions
 - **MLB CVC Survey for 2022: 17% of the transactions included a senior preference, a slight increase from prior years.**
- Straight Preferred (non-participating)
 - **Higher** of (i) [1x]* of the money in plus accrued dividends **or** (ii) common stock equivalent
- Participating Preferred, with or without cap
 - (i) [1x]* of the money in plus accrued dividends **plus** (ii) share with common on common stock equivalent basis (which may be subject to a cap, e.g. capped at 3x of the money in)
 - *May be negotiated as a multiple of the money in; e.g., 2x or 3x of the money in
- **MLB CVC Survey for 2022: Only 24% of the transactions included “participating” preferred stock, while the remaining 76% involved “non-participating” preferred stock**

Governance / Management Issues

Board, Observer or Info Rights Only?

- **Board seat**

- Fiduciary duties
- May not have a meaningful ability to influence

VS.

- **Observation rights**

- Same access to information to allow monitoring of investment, subject to certain exclusions and confidentiality obligations
- No fiduciary duties
- Caution should be taken to avoid being a quasi-director

VS.

- **Information rights only**

- Specified access to information (mostly financial statements), subject to certain exclusions, confidentiality obligations and major investor thresholds
- **[Best Practice]** Usually **critical** for public companies' or foreign corporations' **regulatory and internal requirements**. Therefore, these CVCs will usually want to provide for a separate info right in its **Side Letter** in case it does not meet the Major Threshold status (presently or in the future) or in case the IRA is amended and restated so that the scope of info rights become limited or terminated entirely.

Board Seat

- **The Board of Directors manages the corporation**

- “*The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . .*” Del. Sec. 141.
- All major decisions, such as raising capital or selling the corporation, require Board of Directors’ approval as a first step.

- **Fiduciary duties of directors**

- Imposed by statute for corporations
- Each member of the Board of Directors has a fiduciary duty to **all** stockholders, not just to the group that designated the Board member for election.
- Board members must be careful to separate their actions as Board members from their actions as stockholders. Potential personal liability for breach.
- “**duty of care**” : stay involved and pay attention!
- “**duty of loyalty**”
 - decisions must be made in “best interests” of the portfolio company and (**all of**) its stockholders
 - can present challenges if a vendor/commercial relationship exists
 - prohibits self-dealing

- **Corporate opportunity doctrine**

- may be obliged to pursue opportunities within portfolio company
- incorporate language in investment documents to expressly disclaim this responsibility

Governance / Management Issues: Board or Observer?

- Is a Board seat worth it?
 - Advantage:
 - Provides visibility into company activities and opportunity to vote on certain matters
 - But consider...
 - Who would be the most appropriate CVC representative to serve? Does the CVC have senior representatives who have the time / interest to fill these seats and are willing to be subject to the fiduciary duties / potential liabilities imposed on a director?
 - Increases the potential for conflicts of interests, confidential information misuse and potential scenarios where the CVC director may want to recuse himself or herself from the proceedings (and must obtain corporate opportunities waiver as part of investment).
 - **[Best Practice]:**
 - Often strategic investors are comfortable with a board observer right and/or specified information rights.
 - But typically the company negotiates certain exceptions related to competitors, privileged information, highly proprietary information and conflicts of interest, and also imposes confidentiality obligations as a condition of receipt of such board observer or information rights.

Control Terms: Participation Right and Pay to Play

- **Participation Rights** (aka Preemptive Right): right to purchase pro rata amount in a new equity financing [of at least \$x] – right to maintain their percentage ownership
 - May not apply to all investors, e.g. “Major Investors” only
- **Pay to Play:** Failure of Preferred Holders to purchase pro rata amount of new round results in penalties
 - Often applies only in “down rounds”
 - Penalties are all over the map, including
 - Loss of board seat
 - Loss of anti-dilution protection
 - Loss of pre-emptive right
 - Mandatory conversion to common stock
 - **[Best Practice]** Exemption from “Pay to Play” provisions should be pursued by the CVC because CVCs differ from conventional VCs—CVCs do not usually reserve funds for follow-on investments.
 - MLB CVC Survey for 2022: The survey included one Pay to Play provisions, which is noteworthy since prior surveys did not track any Pay to Play provisions.

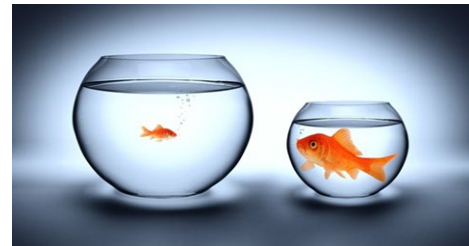


Control Terms: Protective Provisions

- Fundamental issues
 - Sale of the Company & other major transactions
 - Changes to the capital structure
 - Changes to the Charter or by-laws
 - Payment of dividends, redemption of stock, etc.
- Lesser issues
 - Negative covenants to not enter into related party transactions without the approval of the Investor Director
 - Covenant to have employees/consultants enter into CIIA/PIIAs
 - Equity awards and standard vesting schedules
 - D&O or key-man insurance within x days of closing, on terms satisfactory to the Board
- Protective provisions can either be approved by (A) all preferred stock voting together as a single class and/or (B) certain series of preferred stock voting separately.
 - **MLB CVC Survey for 2022: 17% of the transactions included voting rights for the preferred stock as a single class, an increase from prior years.**

Exit Terms: Registration and Redemption Rights

- **Registration rights**
 - more critical to a CVC in a public company scenario
- **Redemption rights**
 - should there be scenarios where the CVC can require the company to buy back its shares?
 - A redemption right is limited by the corporation's ability to make a redemption under applicable law, so does not guarantee the investor liquidity.
 - MLB CVC Survey for 2022: Only 17% of the transactions included some form of redemption rights, while the remaining did not, this was an increase from prior years.



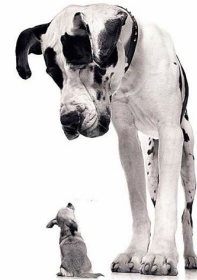
Side Letters

Spectrum of possibilities of path to control provisions (if provided to a CVC) range as follows:

- **Observation rights:** COMMON
- **Notice of sale by Company:** COMMON
 - A right of notice of potential sale of the company (incoming offers and solicitations); usually is offered as a compromise position in lieu of a ROFR or ROFO.
 - Allows for a chance to put a competing offer on table
- **More aggressive strategic rights?**
 - **Right of first offer/negotiation (ROFO)** – LESS COMMON
 - A right of first negotiation provides the CVC with the right to receive information regarding the offer and to make an offer (sometimes requiring parties to negotiate in good faith for a certain period of time), but the company is under no obligation to accept the offer.
 - **Right of first refusal (ROFR)** – EVEN LESS COMMON
 - CVCs are often concerned that the company will be acquired by a competitor, especially in cases where they have co-developed technology with the company that ultimately would be owned by a competitor.
 - CVCs often ask for a ROFR to purchase the company (or a ROFO in the event the company decides to sell) in the event the company receives an offer from a potential suitor.
 - From a VC perspective, this may have a chilling effect on potential offers since acquisition candidates will not want to make an offer that can be topped by an entrenched CVC.
 - **Full option to acquire** – EVEN LESS COMMON
 - Need to determine a buyout formula and a time horizon;
 - The less complete the buyout terms are, the less effective the option to purchase can be in practice.

Side Letter (continued)

- Other Rights often negotiated:
 - Exclusivity
 - Most Favored Nations clause (“**MFN**”)
 - No publicity
 - Excluded Parties
 - Disclaimer of Corporate Opportunity doctrine
- The sophistication of the company’s other investors, as well as the other leverage that a company may or may not have at the time of the CVC investment, relative to the resources provided by the CVC to the company and how valuable the CVC relationship is to the company, will often dictate the outcome of the negotiation of path to control provisions.
- A CVC should also consider the **reputational impact** of seeking path to control provisions and implement clear criteria to determine if it plans to seek them in certain instances but not in other instances.
- **Publicity considerations** – a company will also want to tout its relationship with the CVC so controlling the publicity process contractually is a typical CVC provision included in the Financing Documents or Side Letter



Biography



E. John Park

Silicon Valley

john.park@morganlewis.com

650.843.7595

E. John Park focuses his practice on debt and equity offerings, public securities offerings, recapitalizations, and mergers and acquisitions (M&A). He assists clients at every stage of the business cycle, from initial company formation, venture capital financings, and M&A, to initial public offerings (IPOs), public company reporting, and general corporate counseling. In addition, John represents acquirers and targets in public-private and private-private business combination transactions. John focuses on primarily technology companies in multiple sectors including artificial intelligence, automotive and mobility, cybersecurity, fintech, semiconductor and software, as well as biotechnology companies.

Biography



Matthew H. Lewis

San Francisco

matthew.lewis@morganlewis.com

415.442.1105

Matthew H. Lewis advises clients throughout the United States and abroad on corporate and securities matters. His practice focuses on formation, corporate governance, venture capital, mergers and acquisitions, and capital markets. Prior to joining Morgan Lewis, Matthew worked in the corporate practice groups of a California law firm and a global law firm.

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