

Searching for Venture Capital

Before Anything Else, You Must Be Well Aware of Investors' Requirements

By Marie-Andrée Gravel

It pays to carefully plan your approach if you are expecting to solicit venture capital to sustain the growth of your company, as such thoughtful planning will go a long way toward demonstrating the seriousness of your application. You should know that, in order to protect their investment, venture capital companies put forward specific, scarcely negotiable requirements and this, even though they only hold a minority position in the company.

This second bulletin on venture capital financing summarizes the protection clauses that venture capital companies usually require when investing in a company and sets out the usual protection clauses as well as protection clauses that are specific to this type of investment. In this bulletin, the term "investor" designates the venture capital company while the term "company" refers to the financing recipient.



Usual Protection Clauses

The investor will generally require the usual protection clauses, such as the following:

Preemptive Right

A right that allows the shareholder to acquire additional shares of the company upon their issuance in order to maintain the percentage of his participation in the company.

Right of First Refusal

A right that is granted to a shareholder allowing such shareholder to acquire shares before these shares can be offered or transferred to third parties.

"Coattail" (or "tagalong") right

An undertaking that compels a shareholder who receives a third-party offer to acquire a controlling interest in the company to require that the same offer apply to his fellow shareholders.

"Piggy-back" right

A right that allows a shareholder who received a third party offer to acquire the shares of the company held by the shareholder (usually in the context of a takeover) to compel the other shareholders to sell their shares under the same terms and conditions, to the extent that such is required by the third-party offeror.

Representation of the Investor on the Board of Directors of the Company

The investor requires that one or more of his representatives and sometimes an observer be allowed to sit on the board of directors of the company. Additionally, the investor may require a clause with respect to quorum at the meetings and meeting adjournment in order to ensure his participation or that he will at least be informed of any decision made at the meetings. This requirement often results in the company adopting more formal corporate governance rules than those in effect prior to the investor participation.



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BARRISTERS AND SOLICITORS

Representation of the Investor at Any Committee of the Board of Directors of the Company

The investor requires that one of his representatives participate in certain strategic committees of the company.

Undertaking Not to Compete and Not to Solicit Shareholders and Executive Officers of the Company

The investor may require that the shareholders and/or executive officers of the company refrain from involving themselves in activities that are similar to those carried out by the company and that this undertaking remains in force for a certain period of time within a given territory after the person ceases to be a shareholder and/or executive officer. This covenant is usually coupled with an undertaking not to solicit employees.

For his part, however, in view of the nature of his activities, i.e., investments in start-up companies that may compete with the company, the investor never agrees to non-competition and non-solicitation undertakings in favour of the company.

Representations and Warranties With Respect to the Company and Its Subsidiaries

As for conventional financings, investors require representations and warranties with respect to, among other things, the following items:

- corporate organization;
- share capital;
- legal compliance;
- ownership of assets;
- financial statements, financial and tax situation;
- business operation;
- environment.

This list is not exhaustive and representations and warranties required by the investor may vary according to the nature of the activities carried out by the company.

These representations and warranties are usually accompanied by the personal certificate of an executive officer of the company confirming their truthfulness.

Indemnification

In addition to the due diligence review performed by the investor and the representations and warranties given by the company, investors generally require an indemnification undertaking from the company and/or its managing shareholders.

The indemnification undertaking generally remains in force for (i) a term of two or three years for representations and warranties of a general nature, (ii) a term corresponding to the liability period provided for by law, for instance, in tax or environmental matters, and (iii) an unlimited term in the event of fraud.

Allocation of the Investment Proceeds

In order to protect its investment, the investor sometimes requires that the investment be disbursed subject to certain conditions being fulfilled by the company and to the completion of certain steps. An increasing number of investors divide the process into a number of financing rounds (many disbursements rather than a single one), each of which being dependent upon the preceding one and upon the company reaching certain objectives or results. All the requisites of the preceding financing round must be satisfied anew at the time of these new financing rounds.

Maintenance of Insurance Coverage

The investor who invests in a start-up company is often relying upon the expertise and knowledge of the managing shareholders. As a result, it becomes important for the investor that the company maintains various insurance policies, such as those necessary for carrying out operations as well as life insurance for key executive officers of the company.

In addition, in the event that a representative of the investor sits on the board of directors of the company, the investor requires liability insurance for the directors of the company.

Employment Contracts of Key Executive Officers

The investor who invests in a start-up company is relying upon the expertise of its executive officers and, consequently, requires that these executive officers remain employed by the company. Hiring conditions for the executive officers are generally very strict. They may include, among others, a non-competition undertaking, the duty to reach certain very specific performance objectives and a duty to periodically report



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to the board of directors. In certain cases, the employment contract also provides for severe penalties where the executive officer leaves his employment with the company before a date set by the investor. For example, the shares held by the executive officer who leaves his employment before completion of his employment contract may be bought at a fraction of their value.

Periodical Reports

The investor requires the presentation of periodical reports on the activities of the company (operations, monthly and quarterly financial statements, budgets, etc.)

Specific Protection Clauses

In addition, in view of the form of the investment in start-up companies, either by subscribing shares or by granting loans, the investor has particular requirements with respect to controlled management rights as well as withdrawal and return on investment rights.

Rights of Controlled Management

The investor wishes to control a certain number of decisions of the company in order to protect his investment. In many cases, this control takes the form of a right of veto. Examples of decisions of the company with respect to which the investor may want to exercise his right of veto include:

- changes to the number of directors and the quorum;
- issuance, redemption or purchase of securities;
- declaration and payment of dividends;

- loans that the company may make;
- sale of all of substantially all of the assets of the company;
- acquisition of, or participation in, new companies;
- borrowing / granting of security interests by the company;
- dissolution / winding-up of the company;
- bankruptcy / assignment of its assets by the company;
- material change in the activities of the company;
- appointment of executive officers;
- determination of the remuneration and incentives of key employees;
- appointment and removal of the auditors;
- approval of expenses and budgets;
- hiring and termination of executives;
- signature of material contracts, in particular, employment contracts and contracts pertaining to intellectual property.

When several financial partners invest in a company, the decision-making process is bound to become heavier; this is why the investors sometimes agree to share their controlled management rights (for instance: decision requiring approval by 2/3 of the shareholders/investors).

Withdrawal and Return on Investment Rights ("Put Option")

Investors often require a mechanism whereby they may withdraw at a set date for a set price, which ensures them a predetermined minimum return. Such a

mechanism may take many forms and each investor performs his profitability analysis of the company and determines a strategic withdrawal date.

The withdrawal mechanism is sometimes provided for by creating a distinct class of shares to be issued to the investor, redeemable at the option of the holder in certain specified circumstances and featuring, among others, a priority in the event of liquidation; these shares are usually exchangeable for common shares of the share capital of the company.

Warrants

Investors sometimes require to be issued warrants allowing them to acquire shares of the share capital of the company for a determined period of time at a pre-arranged price (in the hope of benefiting from a price that is lower than the real value).

In Short, Be Prepared!

Reading this bulletin, you now realize that many covenants are involved in the venture capital financing process. Make it easier on yourself and avoid complications by consulting a lawyer.

The next edition of *In Fact and in Law* will be dedicated to the tax aspects of venture capital financing.

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