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Client Alert

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After the Fiscal Cliff: Credit Facilities for Emerging Companies — What to Look for at the Term Sheet Stage

"As venture capitalists continue to be selective (either by choice or due to scarcity of funds) in their additional capital deployments, and as credit remains cheap relative to historical norms, demand from emerging companies for debt is likely to stay strong."

Many of Latham & Watkins' emerging companies clients turn to venture debt facilities to meet at least some of their financing needs. Venture debt facilities are typically provided to emerging companies that are likely to require further equity investments from their venture capital backers. Most of these facilities include a loan (term loan and/or a revolver, typically asset-based) and a warrant.

The demand for venture credit expanded greatly during the Great Recession, and shows no sign of easing. A majority of our venture-backed clients now enter into a venture debt facility during their life cycles. Many enter into two or more venture credit facilities. As venture capitalists continue to be selective (either by choice or due to scarcity of funds) in their additional capital deployments, and as credit remains cheap relative to historical norms, demand from emerging companies for debt is likely to stay strong.

This article highlights some of the key terms we have seen in recent venture credit facilities provided by venture banks and lenders that we suggest be addressed at the term sheet stage. This is not an all-inclusive or exhaustive list. It also does not address many key business terms (including pricing, which is influenced by a multitude of factors such as the venture debt provider's capital base) or the particular circumstances of a given borrower. Furthermore, the following points do not express our opinion or advice with respect to any particular term. Rather, this article highlights some terms that we often see in venture debt financings. Borrowers (many times without the review of counsel) often fail to address these terms at the term sheet stage even though these terms are customarily reflected in the final documentation.

We recommend that emerging companies (and their counsel) negotiate the below terms at the term sheet stage in order to avoid surprises later.

Common Loan Agreement Terms:

Default Rate: Two to three percent was historically the norm for the increase in the interest rate upon an event of default. However, four to five percent is now more common. Some venture credit providers incorporate both a default rate and a late fee, but this is not typical.

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Facility Term: Two to four years, with three years being the most common, is the typical term for venture term loans. A one-year term is most typical for account receivables (A/R) facilities, but two- or three-year terms for larger A/R facilities are also common.

Interest-only Period: Three to 12 months is common for interest-only periods. Nine months is the most typical interest-only period.

Prepayment Fee: A three percent prepayment premium for the first year of a loan decreasing to two percent and one percent for the subsequent years is typical. Many facilities provide for a two percent prepayment premium in the first year, decreasing all the way to zero percent for the remainder of the term; this latter prepayment feature is, however, often coupled with higher exit fees (see below).

Prepayment Mechanics: A few venture credit providers have begun insisting on 10 days or more (some 30 days) for notice of prepayment. Two to three business days' prior notice remains the norm as borrowers often cannot foresee when a refinancing will close more than a few days ahead of such closing. Also, many venture credit providers only permit prepayment of the entire loan. If a borrower needs the flexibility to partially prepay (for maintenance of any covenants or to reduce its debt at the request of equity investors, for example) it should discuss such flexibility at the term sheet stage.

Exit/Terminal Fees: Also known as "back-end" fees. Exit fees (paid at maturity or in connection with a prepayment) of one to three percent of the loan amount are common. Venture credit providers often agree to waive such fees if the facility is refinanced with the same lender. Many venture credit providers view the exit fees as "back-loaded interest" in that they agree to higher exit fees for a reduction in the interest rate. Some borrowers prefer this so as to avoid paying more cash early in the facility's term.

Eligible Foreign A/R: For A/R facilities, the borrower should ensure that all accounts that the borrower expects to be included in the borrowing base are, in fact, included and cannot be arbitrarily removed in the future. Particular attention should be paid to accounts where the account debtor is a foreign entity. Venture banks rarely include such accounts in the borrowing base without appropriate diligence. Some venture banks, however, permit A/R owed by good quality account debtors from the European Union, Japan and South Korea to be included in the borrowing base without approval of each specific account debtor. Additionally, some venture banks (in particular Silicon Valley Bank and Comerica) regularly co-finance working capital lines with the Export-Import Bank of the United States (EXIM) in order to provide foreign A/R sub-facilities guaranteed by EXIM.

Eligible Public Sector A/R: With respect to contracts with the public sector in the United States (Department of Defense, for example), the related accounts are often not eligible without proper assignment to the credit provider under U.S. federal law, which is time consuming and too administratively burdensome for most emerging companies. Some lenders, however, have agreed to permit a certain sublimit of such public sector A/R to be eligible for financing without complete assignment under U.S. federal law.

Banking Relationship: Venture banks regularly require that they become the borrower's primary cash management bank. If a borrower currently has accounts with banks other than the relevant venture bank, it is worthwhile to insert a reasonable timeframe (30 days, for example) after closing to transfer such accounts and to permit all checks to clear from such accounts.

Multiple Advances: Many venture credit providers are funding term loans through multiple advances (rather than one advance on the closing date). Each advance is based on the achievement of certain conditions. The most common condition we see is the requirement to raise a specified amount of additional equity. But achieving certain performance criteria (see below) or meeting a certain financial test are also common conditions. If a borrower agrees to multiple advances, there should be clear, objective criteria for such conditions and discretion should be limited.

Performance Criteria: Venture credit providers may insist on performance criteria, such as achieving certain regulatory milestones, developing certain products, or obtaining rights to certain intellectual property (IP). Such covenants are most common in loans to life sciences companies. Such performance criteria are often specified to be met at the lender's discretion. If the borrower agrees to these terms, there should be clear, objective criteria for such performance covenants and discretion should be limited.

Collateral: A first priority lien on all-assets other than IP with a negative pledge on IP continues to be the norm. But a growing minority of venture lenders have been insisting on IP security, sometimes because of deal specific credit requirements. Borrowers should specify at the term sheet stage any specific carve outs for IP (for exclusive licenses or specific arrangements or collaborations, for example), specific permitted liens or permitted secured indebtedness that the borrower requires. As noted above, negative pledges on IP (meaning that the borrower will not grant a security interest to others in its IP) remain more common than outright grants of security interests in IP. Borrowers who own foreign subsidiaries should specify at the term sheet stage that any security interest in such subsidiaries and their assets will not be perfected as the cost of such perfection typically cannot be justified for venture debt transactions. Finally, if a borrower is likely to take advantage of government support or financing during the term of the venture debt, it should discuss at the term sheet stage any carve outs to the venture credit provider's security interest that may be required to secure such government financing and any accommodations that the venture credit providers will need to make to permit such governmental financing.

Obligations Secured: Many venture credit providers expect that every obligation owed by the borrower to that credit provider be secured, including obligations outside of the given credit facility. Examples of obligations provided outside of specific loan facilities include letters of credit, cash management services and hedging arrangements. Borrowers should be aware when negotiating the term sheets that such obligations will likely be secured and raise any concerns with this approach during the term sheet stage.

Outstanding Debt: Borrowers should disclose all existing debt at the term sheet stage and confirm that the venture debt will be permitted under such existing debt facilities. If any subordination of the existing debt facility to the new venture debt facility is required, then the borrower should confirm that the lender(s) under such existing facility will in fact agree to subordination and under what terms before signing the term sheet.

Account Control Agreements: Venture credit providers have on occasion demanded that account control agreements be conditions precedent to closing rather than conditions subsequent. But most venture credit providers still agree that any required account control agreement may be provided after closing. Borrowers should specify at the term sheet stage whether account control agreements will be required, the timeframe for putting such account control agreements in place (20-30 days is typical in the venture space) and to which accounts (type and

threshold of funds held) such control agreements will apply. Account control agreements are not necessary if the borrower agrees to hold its cash and securities with the venture bank providing the loan.

Landlord Consents and Bailee Waivers: Venture credit providers are generally amenable to landlord consents/bailee waivers being put in place after closing. However, it is worthwhile at the term sheet stage to specify whether such consents/ waivers will be required, which properties are covered (type of property and/or threshold value of property to be covered) and what timeframe will be permitted to put such consents/waivers in place (30 days is typical in the venture space). Most importantly, borrowers should consider specifying the standard for obtaining such consents/waivers. A commercially reasonable efforts standard (meaning the borrower must diligently try to obtain but does not guarantee that it will obtain) is common as landlords/bailees often refuse to enter into the requested waivers at no fault of the borrower. But depending on the value of the collateral being held in a given location, some venture lenders, particularly for equipment financings, insist on landlord/bailee waivers being obtained.

Financial Covenants: Venture credit facilities typically incorporated financial covenants sparingly. But we have seen maintenance covenants, such as adjusted quick ratios, bookings targets, revenue projection tests, EBITDA targets, cash burn targets, or capital expenditure tests, adopted with greater frequency lately. Venture debt term sheets customarily only sketch out the bare details with respect to these financial covenants. Borrowers should ensure at the term sheet stage that the financial covenant formulas are correctly calibrated to the company's specific situation. And if any exceptions are required (such as incorporating certain cash-based accounting concepts for SaaS companies or defining "bookings" to account for company-specific items) that those exceptions be addressed as early as possible.

Minimum Cash Holds: Outright minimum cash hold covenants, whereby a borrower is required to hold a certain amount of cash in an account, are very rare. But some lenders sparingly incorporate "soft" minimum cash hold requirements, whereby if the cash level drops below a certain amount the borrower is required to pay additional interest or other fees. If such minimum cash hold requirements are agreed to, the borrower should assess at the term sheet stage the likelihood of its cash dropping below the required level and whether it would be able (or willing) to incur these additional fees.

No MAC: Borrowers should confirm at the term sheet stage whether a "Material Adverse Change" (MAC) default or ongoing MAC representation will be part of the final documentation. If a MAC will be part of the deal, borrowers should ensure at the term sheet stage that the MAC term is defined as narrowly as possible and not open to far reaching, subjective interpretation. Whether or not a MAC default or ongoing representation is included in the loan documentation, a no MAC representation for each advance that a borrower draws is common.

Investor Abandonment Default: Venture lenders and banks sometimes require investor abandonment defaults (usually in lieu of MAC defaults). These permit lenders to declare a default if they believe that the borrower's investors are abandoning the borrower. Borrowers should discuss whether such a default will be included at the term sheet stage. If the borrower agrees to such a provision, it is worthwhile to specify the objective criteria that trigger the default and that such criteria are not open to interpretation at the lender's discretion. It is not typical for the loss of support from a specific venture capital firm to trigger this default; the default is typically triggered by the actions of the borrower's investors as a whole.

Change in Control Default: Some venture debt "Change of Control" provisions incorporate an investor abandonment default as part of such provision (*i.e.*, if a specific investor sells or transfers its interest in the borrower then a change of control is deemed to have occurred); this is not common as investor abandonment provisions are typically separately documented (please see discussion above). Some "Change of Control" provisions in the venture space also include a board turnover concept (*i.e.*, if a certain number of board members leave or resign during a certain period of time then a change of control is deemed to have occurred); these are also not common.

Change-in-Management Default: Venture credit providers frequently insist on the ability to declare a default when a "change in management" occurs. The venture credit provider usually requests that such default be triggered when any key management member departs. If a "change in management" default is included, then the parties should specify at the term sheet stage the positions to which such default would apply and whether a change in all of the top management positions at the same time (CTO, COO, CFO and CEO) is required to trigger this default. Also, typically such defaults do not apply if within a certain period (typically 90-120 days) the borrower's board appoints a new person to fill any open position.

No Assignment: Venture credit providers frequently insist on being able to assign their interest in the loans to any entity without notice to the borrower. Borrowers have on occasion limited these assignment provisions so that the venture credit provider (a) must give notice, (b) may only assign, unless an event of default exists, to credit-worthy entities and (c) may not assign to competitors of the borrower or to vulture/distressed debt funds. Borrowers should discuss this issue at the term sheet stage, particularly if assignments to competitors of the borrower or vulture funds are a concern.

Common Warrant Terms:

Amount of Warrant: Venture credit providers typically request warrants equal to one and a half to five percent of the loan amount (although some venture lenders request in the 10 percent range), largely depending on their valuation of the borrower (although some venture credit providers seem to demand a set percentage, regardless of the valuation). The borrower should confirm at the term sheet stage whether the warrant amount is to be based on the amount actually drawn at closing or the entire facility. Borrowers will also want to confirm whether a charter amendment is required to authorize more shares to cover the warrant.

Exercise Price: The exercise price of a warrant is based on the price of the shares underlying the warrant. If it is a common stock warrant, this is typically the most recent per share fair market value of a borrower's common stock as determined by its board of directors. If it is a preferred stock warrant, it is the per share price for the series of preferred stock in the most recent financing where preferred stock was sold. Preferred stock warrants are more common than common stock warrants. In any case, the determination of the warrant price should be specified at the term sheet stage.

Warrant Expiration: Warrants typically expire seven to 10 years after the loan transaction is closed, with a 10-year expiration being the most typical.

Anti-dilution Provisions: Venture credit providers often request specific anti-dilution protection on a preferred stock warrant. In general, borrowers will insist that venture credit providers do not receive any more protection than the borrower's

other investors. Consequently, venture credit providers will often agree to rely on the protections for preferred stock already provided under the borrower's charter without additional anti-dilution protection.

Treatment of Warrants upon an Exit Event: Venture credit providers will often request that a warrant be automatically assumed by the acquirer in a sale of the borrower. This is not customary as acquirers resist continuing any relationship with the venture credit provider. Consequently, venture credit providers will often agree that upon a sale of the borrower the warrant will be exercisable for cash or publicly traded securities, or a combination of the two. Unlike the typical result in a sale of the borrower, warrants granted to venture lenders/banks often remain outstanding following an initial public offering.

Registration Rights: Venture credit providers have historically requested registration rights, though they are rarely used. If provided, such registration rights are customarily structured to "piggyback" on the sale of shares in a public offering or as rights to sell shares in a secondary offering on Form S-3. If the borrower is agreeable to providing such rights, the borrower should confirm that the venture credit provider agrees to be subject to the terms of the borrower's existing registration rights agreement.

Information/Notice Rights: Venture credit providers often request that information rights be included in the warrant. This is not typical, particularly if the more fulsome delivery requirement under the loan continues under the warrant even after the loan is paid off. The warrant is customarily limited to receipt of notice that a major event, such as a stock offering, an IPO or a sale of the borrower, has occurred. If a venture credit provider requires ongoing financial information of the company for regulatory purposes or to track its position, such information is more typically provided for in a management rights letter or similar document.

Voting Agreements: Borrowers will want to confirm at the term sheet stage that the venture credit provider will agree to become a party to or otherwise be bound by the borrower's existing voting agreement upon exercise of the warrant.

Transfer Restrictions and Market Standoff Agreement: Venture credit providers often do not want to limit their ability to sell the shares exercised under a warrant. Venture warrants, however, often include restrictions on transfer (with customary exceptions, such as certain transfers to affiliates) similar to those agreed to by the borrower's other investors and a "market standoff" provision, whereby the venture credit provider agrees not to sell or transfer its shares for 180 days or longer following an initial public offering. Emerging companies should make sure to be on the same page with the venture credit provider on transfer restrictions and the "market standoff" provision at the term sheet stage so as to avoid any surprises.

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