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STRUCTURING VENTURE CAPITAL (VC) DEALS:

LEGAL STRATEGIES TO PROTECT VC INTEREST

INTRODUCTION

In today's world, technological innovation and economic advancement are largely driven by Venture Capital (VC). Venture capital deals are critical in triggering the growth of innovative startups with a potential for rapid development by providing the necessary funding to boost operations, accelerate growth and penetrate new markets.

Superficially, it appears straightforward to strike a deal with the model of raising capital to invest in early and growth-stage companies. However, in an ever-changing VC industry where innovations are accompanied by a large element of risk, there are multiple dynamics underpinning choices of VCs when aiming at sustainable growth and Returns on Investment (ROI)

VC success rates vary widely though it is generally accepted that a significant portion of funds do not achieve their target returns.[1] According to some industry reports, only about 5% of VC funds generate 95% of the industry's returns. A 2023 study by Cambridge Associates found that the 20-year annualized average return[2] for VC funds was 12.33% compared with 12.40% for the MSCI All-Country World Index of global stocks.[3] Meanwhile, research from Harvard Business School suggests that as many as 75% of venture-backed companies never return cash to investors.[4]

Thus, at different VC rounds, whether at the seed round, Series A, B and C, for a VC, structuring deals in a way that protects their interests while fostering the growth of the investee company is crucial. Much more than the business strategies that most VCs would focus on, proper structuring of a VC deal requires employing effective legal strategies such as conducting due diligence and clear positions on Intellectual Property (IP) Rights, amongst others.

This article examines key legal strategies to ensure VCs are well-protected throughout the investment lifecycle while accelerating the growth of investee startups.

1.Akhilesh Ganti, "Venture Capitalists: Who Are They and What Do They Do?"(2024),https://www.investopedia.com/terms/v/venturecapitalist.asp(last accessed 28/08/2024)
2.https://www.forbes.com/sites/dileeprao/2023/04/14/20-vcs-capture-95-of-vc-profits-implications-for-entrepreneurs--venture-ecosystems/?sh=3fe588734bf2 (last accessed 06/09/2024)
3 Cambridge Associates, "U.S. Venture Capital Index and Selected Benchmark Statistics" https://www.cambridgeassociates.com/wp-content/uploads/2023/10/WEB-2023-Q2-USVC-Benchmark-Book.pdf, Page 3 (last accessed 05/09/2024)
4 Fast Company. "Why Most Venture-Backed Companies Fail https://www.fastcompany.com/3003827/why-most-venture-backed-companies-fail (last accessed 05/09/2024)

KEY LEGAL STRATEGIES TO PROTECT VC INTEREST

1. Due Diligence: The Foundation of a Strong Deal

Investing in early-stage companies is risky; hence, before any capital changes hands, there is a need to conduct comprehensive due diligence on the investee company, identify red flags, and implement a risk mitigation strategy to secure potential investments. This process involves a meticulous examination of the startup's financial health, intellectual property (IP), legal compliance, market position, and the competence of the management team.

Due diligence involves the meticulous evaluation of the business and legal aspects of the opportunity to assess the risks of investing and develop a risk mitigation plan where the VC is willing to take the risk of investing in such a startup.

With due diligence, VCs can examine the startup's financial health, intellectual property (IP), legal compliance, market position, the competence of the management team, validate information, prepare to negotiate terms and make well-informed investment decisions.

1.1 Identifying Red Flags
Through comprehensive legal due diligence, VCs can uncover red flags which pose potential risks. Some of the red flags which may be identified during legal due diligence include:

(i) Intellectual property issues such as unclear IP ownership, unsigned IP assignment agreements or pending disputes that may threaten a startup's core assets. This can be resolved by confirming IP assignments and securing necessary licenses.

(ii) Regulatory non-compliance such as violations of industry regulations and regulatory requirements which attract fines or operational disruptions. For instance, in countries like Kenya and Nigeria, in the processing of personal data, failure to register as a Data Controller/Processor, or to put in place the necessary data privacy and protection policies and measures attract heavy penalties which may impact the startup's return on investment. By conducting a thorough regulatory review and implementing corrective measures, this potential risk may be addressed by VCs.

(iii) Undisclosed liabilities such as hidden debts or obligations such as pending litigation, and unreported taxes which can affect the financial performance and stability of the startup. VCs should demand full disclosure and renegotiate the terms of the deal where a red flag as this is identified.

(iv) Incomplete and inaccurate corporate records, for instance, failure to reflect the exit of a shareholder or director on the incorporation documents of the investee company, missing and outdated records like shareholders' agreements. VCs may mitigate the potential risks which may arise from this red flag by requesting updated documentation and ensuring compliance.

1.2 Salient Questions VCs Should Ask During Legal Due Diligence

✓Does the company have clear ownership of its Intellectual Property (Do you own patents or trademarks)?
✓Are there clear and updated corporate records, including incorporation documents and shareholders' agreements?
Is the company compliant with all relevant industry regulations and licensing requirements?
✓Is the company involved in any pending litigation?
✓Are employment contracts in place and do they comply with the relevant local laws?

Conducting a meticulous due diligence enables VCs to uncover potential risks. Addressing these issues before finalising the deal can save time and resources and prevent future conflicts. If significant red flags emerge, VCs should be prepared to renegotiate terms or walk away from the deal.

2. Term Sheet Negotiation: Setting the Stage

Negotiating a term sheet is one of the crucial legal strategies VCs should engage in. The term sheet enables the VCs to streamline the discussions with the start-up to what is important, negotiate and resolve the important points early, protect their interests and get the deal closed as quickly as possible.

Thus, the term sheet outlines the key terms and conditions of the investment and serves as the blueprint for the final deal. It is where VCs can assert their interests by negotiating terms that balance risk and reward.

2.1 Key Provisions VCs should Include In a Term Sheet to Protect their Interests

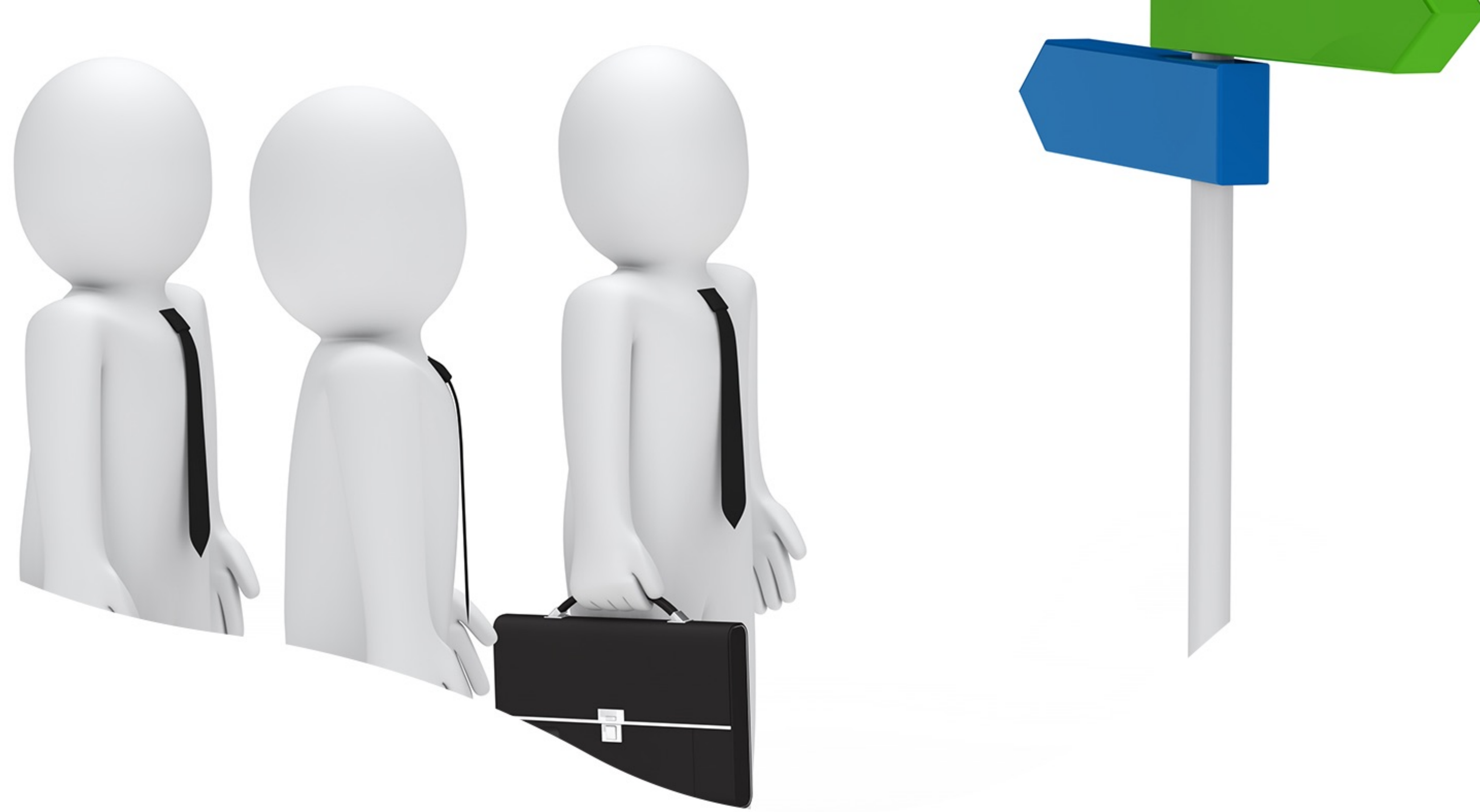
2.1.1 Provisions that impact valuation and economic division upon a liquidity event

The valuation of the start-up over time usually determines the VC's return on investment, thus provisions which impact the valuation of the start-up and ensure the VC's return on investment and economic division upon a liquidity event should be included in the Term Sheet. Some of these provisions include:

- ✔Provisions on liquidation preferences where the investee company is dissolved or sold.
- ✔Provisions which require the vesting of founders' shares over some time. This is to create an incentive for founders to remain in the Company particularly where a large portion of the investee company lies in the "talent capital" of the founders. The potential dilutive effect of filing a position vacated by an exiting founder.
- ✔Provisions on the reimbursement of legal, due diligence, and administrative costs incurred during the financing process by the VC.
- ✔Vesting provisions which apply to the provision of compensation to employees in the form of employee stock options, as Investors want to ensure that key employees remain committed to the Company.

2.1.2 Provisions that impact control over decision making

VCs usually acquire minority stakes in the start-up. However, provisions which impact and control the decision-making process of the start-up should be included in the Term Sheet. This is because the relationship between the VCs and start-ups is usually long-term, and the returns of the VCs' investment are hinged on the investee company's increased growth and valuation over time. Thus, there is a need for VCs to be actively engaged in guiding start-ups and ensuring that they make decisions which will foster their growth and profitability. Below are some provisions which should be included in a Term Sheet to control decision-making:



✓Provisions requiring the amendment of the relevant incorporation documents to allow the investors to appoint member(s) of the Board of Directors.
✓Provisions on Investor Rights which contain corporate activities that require approval by the director appointed by the Investors.
✓Special Class Voting Rights which grants the investor special approval rights in respect of certain matters of particular significance to their Investment, in addition to class or series voting rights that may exist under relevant corporate laws.
✓Provisions which require employees of the Company to execute Non-Compete and Non-Solicitation Agreements.

2.1.3 Reasonable Market Investor Protection Provisions

Some of the reasonable market investor protection provisions which VCs should include in a term sheet to protect their interests include and are not limited to:
✓Anti-Dilution Provisions
✓Representation and Warranties
✓Confirmation that employees of the Company execute Confidentiality and Invention Assignment Agreements to ensure that the Company owns all intellectual property.

3. Setting Clear Terms on IP and Proprietary Rights

In venture capital, Intellectual Property (IP) often represents the backbone of a startup's value, as it is usually the most valuable asset of modern start-ups. As a result, IP protection is of topmost priority to VCs as their interests are hinged heavily on this.

Lapses in IP protection can lead to significant legal and financial challenges down the line. For VCs investing in early-stage companies, the protection and clear assignment of IP rights are non-negotiable. Below are key legal strategies to ensure the protection of the VCs' interests:
✓Ensuring Proper IP Registration and Assignment and if the IP originated with founders or employees, ensuring that clear assignment agreements are executed.

Verify that founders, especially those contributing key technical assets (e.g., source code, patents), have signed IP assignment agreements transferring ownership of all relevant IP to the company.

✔ Before finalizing a deal, VCs should ensure that all IP is either registered or in the process of being registered in the company's name, eliminating future ownership disputes.

✔ Inclusion of indemnification clauses, protecting the VC from potential legal challenges or financial losses arising from disputes over ownership.

4. Collaboration with Local VC Legal Experts in Cross-Border VC Deals: A Strategic Imperative

As the venture capital landscape increasingly becomes global, this is perhaps the most crucial legal strategy VCs should readily employ before striking any VC deal, especially for cross-border deals where they are unfamiliar with the local securities and investment laws and regulations of the jurisdiction where the deal takes place. Adhering to securities regulations is critical to avoid legal penalties and ensure the deal's validity.

Thus, VCs seeking to protect their interests should form partnerships and collaborations with local counsel in such jurisdictions who will provide real-time advice on the viability of investing in the start-ups, the status of the start-ups in terms of compliance with regulatory laws and licensing requirements and specialized advisory on navigating the complexities of cross-border deals.

4.1 Case Study: Expanding into Emerging Markets

Consider a VC firm based in the United States looking to invest in a Nigerian fintech startup. The startup shows great promise, operating in a burgeoning market with a high demand for digital financial services. However, Nigeria's regulatory landscape for fintech is still evolving, with specific laws governing electronic payments, financial services, and data protection. Additionally, navigating Nigeria's foreign investment rules and repatriation of funds adds another layer of complexity.

In this scenario, the VC firm's legal team has the expertise to draft comprehensive agreements that comply with U.S. and international standards, but they may not be fully familiar with the nuances of Nigerian law. This is where collaboration with local counsel becomes indispensable.

4.3 Best Practices for Collaborating with Local Counsel in Cross-Border Deals

✔Local counsel should be involved from the earliest stages of deal structuring. This enables them to provide proactive advice on potential risks and help shape the investment strategy.

✔Local counsel should be involved in the due diligence phase, particularly when assessing compliance with local laws, reviewing contracts, and identifying red flags. By this, VCs can ensure a meticulous and tailored due diligence process that addresses peculiar risks in the target country.

✔Seamless communication between the VC's in-house or lead counsel and the local counsel ensuring that the local counsel's input is integrated into the overall legal strategy, particularly when drafting contracts, negotiating terms, or structuring the deal to comply with both jurisdictions' laws.

✔Engage local counsel to provide critical advice on the best exit strategies based on the local legal landscape and ways to ensure that the VC can exit the investment in a legally compliant and financially efficient manner

✔Engagement of ongoing support of local counsel who will keep VCs informed of potential regulatory changes in the target country that could impact their investment. For example, shifts in tax law, foreign ownership restrictions, or changes in data protection regulations can significantly affect the success of the VCs' investment

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CONCLUSION

In the dynamic and often high-risk world of venture capital, safeguarding the interests of investors requires more than just financial acumen—it demands a comprehensive legal strategy. From ensuring thorough due diligence to setting clear terms on IP and proprietary rights, VCs must proactively address the potential pitfalls that can undermine their investments.

Collaborating with local counsel in cross-border deals further strengthens this framework, offering invaluable insights into local regulations, cultural nuances, and potential legal risks in foreign markets. By integrating these strategies VCs can navigate complex transactions with confidence.

Ultimately, venture capital success hinges on the careful structuring of deals that not only fuel innovation but also protect investments. Legal due diligence, clear contractual terms, and expert local guidance are the pillars upon which sustainable, high-yielding venture capital deals are built.

Famsville is a law firm with specialized expertise in structuring venture capital deals, legal due diligence and expert local guidance.

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