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CORPORATE VENTURE CAPITAL (CVC) INVESTMENT IN US STARTUPS

(PART II) GETTING THE DEAL DONE: KEY TERMS AND CONSIDERATION

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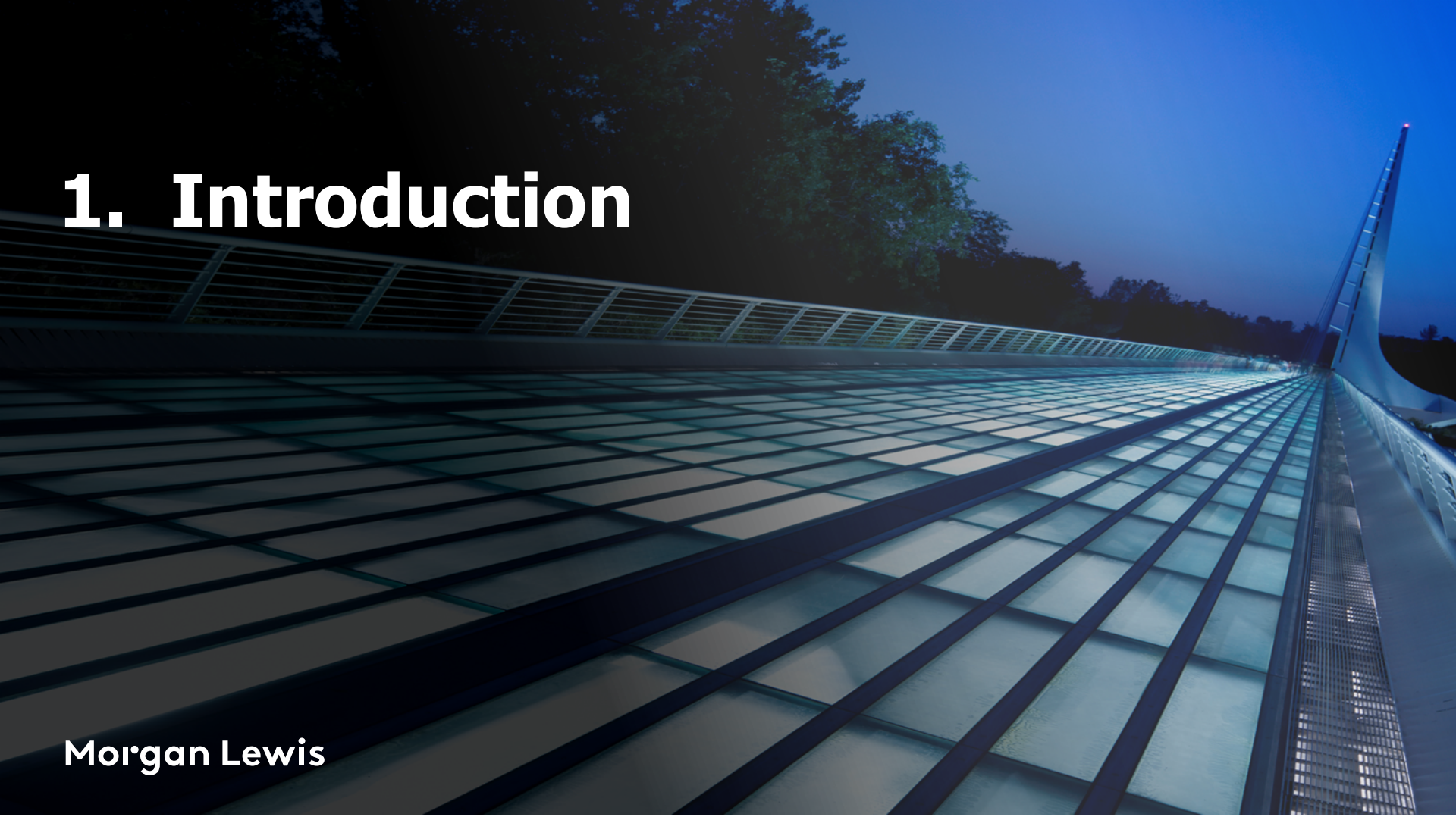

1. Introduction

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Presenters

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Problems of CVC in Japan (1)

- Purpose of CVC is not clarified in the company
- Insufficient internal coordination in the company
- Lack of authority within the department in charge and time-consuming decision making
- Seeking friendly relationships rather than tough contract negotiations
- Reluctance to accept management from outside the company
- Difficult to coordinate team up, positioning, investment cycle (e.g., background, compensation, term of office)
- Lack of focus on financial return
- Various strategic return objectives, which make it difficult to evaluate the performance
- Insufficient expertise in investments and price calculation (Many people come from consulting firms or finance institutions and do not have much business experience)
- Risk averse attitude and tendency to avoid litigation
- Withdrawal from the business as soon as performance has deteriorated

⇒ Japan's traditional corporate culture and organization sometimes may not conform with the elements necessary for CVC to succeed

Problems of CVC in Japan (2)

In order to solve the problems:

- Establish clear objectives (but retain flexibility for change depending on circumstances)
- Include persons with sufficient knowledge and experience in VC in the team
- Develop a deal strategy in advance (otherwise you will be late)
- Obtain clear commitment and support from the management (big picture decisions may be necessary)
- Understand what startups want and provide it (may not be just money)
- Tackle with a long-term view
- Understand uniqueness of Silicon Valley style deal negotiations

  ⇒ Consider seeking assistance from advisors with sufficient experience in startup investments in the US

2. Features of CVC investments

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Features of CVC Investments

- Investments based on strategic reasons
  - Not only for purposes of capital gains
  - Long-term partnership with target company (venture investments + business alliance)
- Corporate governance
  - Rights to appoint Directors, Observer Rights, Information Rights
  - Restrictions on management, Protective Provisions
- Exit strategy: Liquidation Preference, Redemption Rights, Registration Rights, Drag-Along Rights
- Intellectual property rights:

  Existing intellectual property rights + Acquisition of new intellectual propery rights and technology through new business and technology development
- Key Employees: Attracting and retaining talented people to stay with the company

Features of CVC Investments

Key Agreements and Documents for CVC Investments

- Term Sheet
- Amended and Restated Certificate of Incorporation
- Stock Purchase Agreement
- Schedule of Exceptions (exceptions to representations and warranties in Stock Purchase Agreements)
- Investor Rights Agreement
- Voting Agreement
- Right of First Refusal and Co-Sale Agreement
- Legal Opinion of company counsel
- Side Letter (document describing terms and conditions agreed upon with particular investor)

3. Key Terms for CVC Investments

(1) Liquidation Preference

(2) Redemption Rights

(3) Protective Provisions

(4) Anti-Dilution Rights

(5) Right of First Refusal

(6) Information Rights

(7) Voting Rights

(1) Liquidation Preference

- Upon dissolution or liquidation of the issuing company, the residual assets of the company will first be distributed to Preferred Stockholders up to the amount of their investments, then the remaining amount will be distributed on a pro rata basis to Common Stockholders (or all Stockholders including Common Stockholders)

  Example: Preferred Stock Price = $1.00 per share

  Number of Preferred Stocks issued and outstanding = 2,000,000 shares

  If the amount of residual assets are $4,500,000, Preferred Stockholders are entitled to a distribution of $2,000,000 ($1.00 x 2,000,000 shares) ahead of and in preference to Common Stockholders

- Participating or Non-Participating Preferred Stock
  - Participating Preferred Stock: may participate in pro rata distribution with Common Stockholders after the distribution to Preferred Stockholders
  - Non-Participating Preferred Stock: after the distribution to Preferred Stockholders, only Common Stockholders may participate in pro rata distribution

(1) Liquidation Preference

- Adjustments in Non-Participating Preferred Stock

  In the case of Non-Participating Preferred Stock, if the amount of pro rata distribution as a Common Stockholder is greater than the amount of distribution as a Preferred Stockholder, Preferred Stockholders may receive a pro rata distribution together with the Common Stockholder

  Example: Total investment amount by Preferred Stockholders = $1,000,000

  Preferred Stockholder's shareholding ratio = 30%

  For example, if the residual assets are $20,000,000, it is more favorable to receive a pro rata distribution of $6,000,000 ($20,000,000 x 30%) together with Common Stockholders than a distribution of $1,000,000 (total investment amount) as Preferred Stockholders

- Under the definition of "Deemed Liquidation", the proceeds of the acquisition of the issuing company is also considered as residual assets and subject to Liquidation Preference
- The residual assets after completion of payment to all creditors are legally distributable to Stockholders (available proceeds)

(2) Redemption Rights

- Two types of Redemption Rights: Preferred Stockholder's Redemption Rights and the issuing company's Redemption Rights (mandatory redemption)
- Redemption Rights by Preferred Stockholders are equivalent to put option rights.
- Whether to grant Preferred Stockholders a right to receive the amount in excess of their investments upon redemption is a matter of negotiation
- Redemption must be done to the extent permitted under applicable law
- Recent case law implicates that it may be a breach of fiduciary duties of the Board of Directors to allow redemptions upon request of Preferred Stockholders
- As an alternative to Redemption Rights, it is possible to grant investors a right to force the issuing company to pursue an exit strategy

(3) Protective Provisions

- In addition to voting rights of Preferred Stockholders which are the same as those of Common Stockholders, the right to consent or object to certain important actions by the issuing company by resolution of Preferred Stockholders only (class voting)

  Examples: (1) Change in terms of Preferred Stock, (2) Issuance of stocks preferred to Preferred Stock, (3) Sale of the issuing company through M&A, (4) Merger or other reorganization, (5) Dissolution or commencement of bankruptcy proceedings, (6) Change in business purpose, (7) Transfer of material business, (8) Intercompany transactions with conflict of interest, and (9) Indebtedness for borrowed monetary exceeding a certain amount

- Separately from Protective Provisions under applicable law and certificate of incorporation, veto rights by Directors appointed by Preferred Stockholders are provided under Investor Rights Agreement
- From the viewpoint of the issuing company and its founder, Protective Provisions would constrain the management of the company, and items to be included in Protective Provisions are heavily negotiated

(4) Anti-Dilution Rights

- Rights to adjust downward the conversion price of Preferred Stock into Common Stock when the company issues new stocks at a price lower than the price at which the Preferred Stockholders made investments, allowing the Preferred Stockholders to acquire more Common Stocks upon conversion
- A downward adjustment to the conversion price is necessary because the value of the stocks will decrease if new stocks are issued at a price lower than the price at which the Preferred Stockholders made investments, and the shareholding ratio will decrease if the Preferred Stocks are converted into Common Stocks at the original conversion price
- The most favorable anti-dilution right for investors is called "Ratchet Formula", but there are various other calculation methods

(4) Anti-Dilution Rights

Example of Full Rachet Anti-Dilution Provision

- Before issuance of new stocks:

Common Stock:	1,500,000 shares
Series A Preferred Stock:	2,500,000 shares (conversion price of $1.00 per share)
Options:	1,000,000 shares
Total:	6,000,000 shares

- Issuance of new stocks (at a price lower than the issued and outstanding shares)

  Issued 2,000,000 shares of Series B Preferred Stock at $0.50 per share (total issue price $1,000,000)

- New conversion price for Series A Preferred Stock = $0.50 per share
- Number of shares of Common Stock available upon conversion of Series A Preferred Stock

  2,500,000 x ($1.00/$0.50) = 5,000,000 shares

(4) Anti-Dilution Rights

Example of Broad-Based Anti-Dilution Provision

- New conversion price of Series A Preferred Stock = CP x (A+B) / (A+C)

  CP = Conversion price before new stocks are issued ($1.00 per share)

  A = Number of shares of Common Stock immediately prior to the issuance of new stocks (including potential shares to be issued upon conversion of Series A Preferred Stock into Common Stock and exercise of options)

  B = Number of shares required to achieve the intended financing, assuming that new stocks are issued at the original conversion price (CP) at issuance of new stocks (amount raised by the issuance of new stocks / CP)

  C = Number of shares to be issued upon issuance of new stocks

- New conversion price for Series A Preferred Stock

  $1.00 x (6,000,000 + 1,000,000) / (6,000,000 + 2,000,000) = $1.00 x 7/8 = $0.875 (per share)

- Number of shares of Common Stock available upon conversion of Series A Preferred Stock

  2,500,000 x ($1.00/$0.875) = 2,857,142 shares

(5) Right of First Refusal

Right of First Refusal by Investors

- When the company issues new stocks, existing stockholders may request for the stocks to be allocated to themselves in proportion to their shareholding ratio
- The purpose of Rights of First Refusal is to maintain the shareholding ratio of existing stockholders because the shareholding ratio of existing stockholders decreases if new stocks are allocated to a third party
- Rights of First Refusal are often granted only to Major Investors

(6) Information Rights

- Investor's rights to receive information from the issuing company regarding its financial conditions and business operations
- While Delaware and California laws provide minimum Information Rights to receive financial statements, the right to receive more detailed information regarding the issuing company's business (e.g., budgets, business plans, information about employees and customers) needs be separately set forth in the agreement
- If an investor wants to receive particular information, Information Rights can be set forth in a side letter separately agreed between the issuing company and the investor
- Information Rights are usually granted only to Major Investors, the definition of "Major Investors" under the agreement is important
- Information Rights include the right to visit and inspect the issuing company as well as the right to speak with the its management team

(6) Information Rights

- Observer Rights
  - Rights to participate in the Board meetings as an observer (but no voting rights)
  - Considering the risk of personal liability as a Director, investors may prefer Observer Rights to the right to appoint Directors
- Investors often request disclosure of documents presented at the Board meeting of the issuing company, even if they do not have rights to appoint Directors or Observer Rights

(7) Voting Rights

- When Preferred Stockholders exercise their Voting ights together with Common Stockholders, the number of Voting Rights is calculated based on the number of shares if the Preferred shares were to be converted into Common Stocks (fully-diluted)
- Class voting requirements may be imposed by law and the certificate of incorporations (e.g., amendments to the certificate of incorporation affecting the rights of certain class of shares, mergers and other reorganizations). Particularly, California law imposes many class voting requirements
- Preferred Stockholders often have rights to appoint and remove Directors
- Directors appointed by particular class of Preferred Stockholders can be removed only by that class of Preferred Stockholders
- Most companies provide the number of Directors in the by-laws or the Board resolution (unanimous written consent), rather than the certificate of incorporation
- The terms and conditions regarding Voting Rights are set forth in the certificate of incorporation, Investor Rights Agreement and Voting Agreement

4. Committee on Foreign Investment in the United States (CFIUS)

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Committee on Foreign Investment in the United States (CFIUS)

Committee on Foreign Investment in the United States

- The Foreign Investment Risk Review Modernization Act (FIRRMA), passed in 2018, allows not only acquisition of control of a US company by non-US investors, but also investments in "critical technology," "critical infrastructure," and "sensitive personal data" to be subject to review by CFIUS

Mandatory Filing / Voluntary Filing

- The FIRRMA added mandatory filing requirements for certain investments involving critical technology and involving foreign government-related persons
- Even where there is not a mandatory filing requirement, there are many cases where a joint voluntary notice is filed in practice in order to avoid the risk that CFIUS will negate the transaction after the closing

Committee on Foreign Investment in the United States (CFIUS)

Schedule of Joint Voluntary Notice

- Review period: 90 days (45 days for initial review + potential 45 days for additional review)
- If the review is not completed within 90 days, CFIUS may request to withdraw the application
- Generally 1-2 months of preparation is necessary prior to the formal application
- Informal negotiations often take place with draft notice prior to the formal application

Declaration

- Implemented by FIRRMA in 2018
- Review period: 30 days
- Review period can be shortened if clearance is obtained after the review, but CFIUS may request a full filing, in which case additional 90-days review period is required from that point

Committee on Foreign Investment in the United States (CFIUS)

Consequences after completion of CFIUS review

- Clearance (without mitigation agreement)
  - CFIUS will no longer challenge the transaction (safe harbor)
- Clearance (with mitigation agreement)
  - By executing the mitigation agreement, CFIUS will continue to monitor the transaction after the closing
- Prohibition of transactions / Divestment

Penalties

- Submission of false information: $250,000 per case
- Breach of mitigation agreement: $250,000 or the amount of investment, whichever is higher

* If the transaction is consummated without CFIUS filing, there is a risk that CFIUS will negate the transaction after the closing and the investment will need to be divested


5. Key Takeaways
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Key Takeaways

Best Practice

- Meticulous contract drafting
- Efforts for tough contract negotiation
- Preparation of clear cap table (pre-money and post-money)
- Silicon Valley style equity incentives and contingency fees
- Preparation for litigation which is an unavoidable cost of doing business in the US
- Attorney's role not only as a "legal professional" but also as a "business partner"
- Seeking assistance from advisors with sufficient experience in US market and CVC practice

Next Webinar

CVC Investments in the Life Sciences Industry:

Key IP Issues and Conducting IP Due Diligence

Date:	Thursday, April 20, 2023 / 5:00 pm PT
	Thursday, April 20, 2023 / 8:00 pm ET
	Friday, April 21, 2023 / 9:00 am JST
Presenters:	Janice H. Logan, Ph.D. (Washington DC & Tokyo Offices)
	Min Woo Park, Ph.D. (Washington DC Office)
	Motonori Araki (Tokyo and New York Offices)

Biography

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Nancy Yamaguchi advises global technology companies on cross-border mergers and acquisitions (M&A), strategic and venture capital investments, joint ventures, strategic alliances, technology transactions, and licensing. With more than 20 years of experience, Nancy is a trusted advisor to private and public multinational companies, especially those based in the United States and Japan, on all aspects of their corporate legal needs, including inbound and outbound M&A transactions.

Nancy is ranked Band 1 for Corporate/M&A: Deals in Asia by Chambers and recognized by clients as having “a business mind and tremendous attention to detail." They commend her for being “excellent and speaking fluent Japanese but also able to translate the cultural context and is amazing when dealing with the Japanese government.” In addition, they note that “she is great at negotiation and everything legal and is extremely helpful in concluding multinational deals.“

Education:

- Northwestern University Pritzker School of Law, J.D., cum laude
- Harvard University, A.M.
- Georgetown University, B.A.

Biography

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Narumi is licensed to practice law in Japan, California, and New York, and advises on various cross-border transactions and investments, particularly those based in Japan and the United States. He assists Japanese and non-Japanese companies on mergers and acquisitions, corporate venture capital (CVC) and other venture capital or strategic investments, other equity or debt financings, joint ventures, corporate formation and governance, foreign direct investment regulations, and privacy law, particularly in the semiconductor, banking, FinTech, IT, software, automotive, bio-pharmaceutical and medical technology (MedTech) industries. He also advises on Japan's financial regulatory matters with a particular focus on the formation, registration, and operation of investment funds.

Prior to joining Morgan Lewis, he worked at one of the largest law firms in Japan for approximately 10 years, and also worked at the Financial Services Agency as a legislative officer in charge of financial regulations, including the Financial Instruments and Exchange Act. In addition, he has experience in structuring structured finance transactions for a major Japanese securities firm.

Prior to joining Morgan Lewis, Narumi worked for nearly 10 years at one of the largest Japanese law firms. In addition, he served as a public officer of the Financial Services Agency of Japan, where he was in charge of drafting financial regulatory provisions such as the Financial Instruments and Exchange Act. He also has experience in working at a Japanese securities company, where he dealt with structuring complex finance transactions.

Education:

- University of California, Los Angeles School of Law, LL.M.
- University of Tokyo Faculty of Law, LL.B.

Biography

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Tomoko Fuminaga, a licensed Japanese lawyer (bengoshi) partner, provides advice concerning financial regulatory and general corporate matters. With respect to fund matters, she counsels clients on structuring and distributing investment funds for Japanese investors, registering their Japan presence in Japan as financial instruments business operators, compliance, inspection preparation, and support and crisis management. In addition, she provides advice concerning market regulations, corporate governance, and shareholder proposals. She also counsels on establishing, licensing, and operating businesses for Japanese/foreign financial institutions not related to funds.

Additionally, Tomoko represents financial institutions and other clients on cross-border mergers and acquisitions transactions and provides legal services in connection with corporate and anti-monopoly law matters.

Tomoko began her practice as a licensed Japanese lawyer (Bengoshi) after working several years for a major Japanese bank. She is a bengoshi partner at the Morgan, Lewis & Bockius Law Offices/Morgan, Lewis & Bockius LLP (Foreign Law Joint Enterprise) in Japan.

Education:

- New York University, LL.M.
- Waseda University, LL.B.

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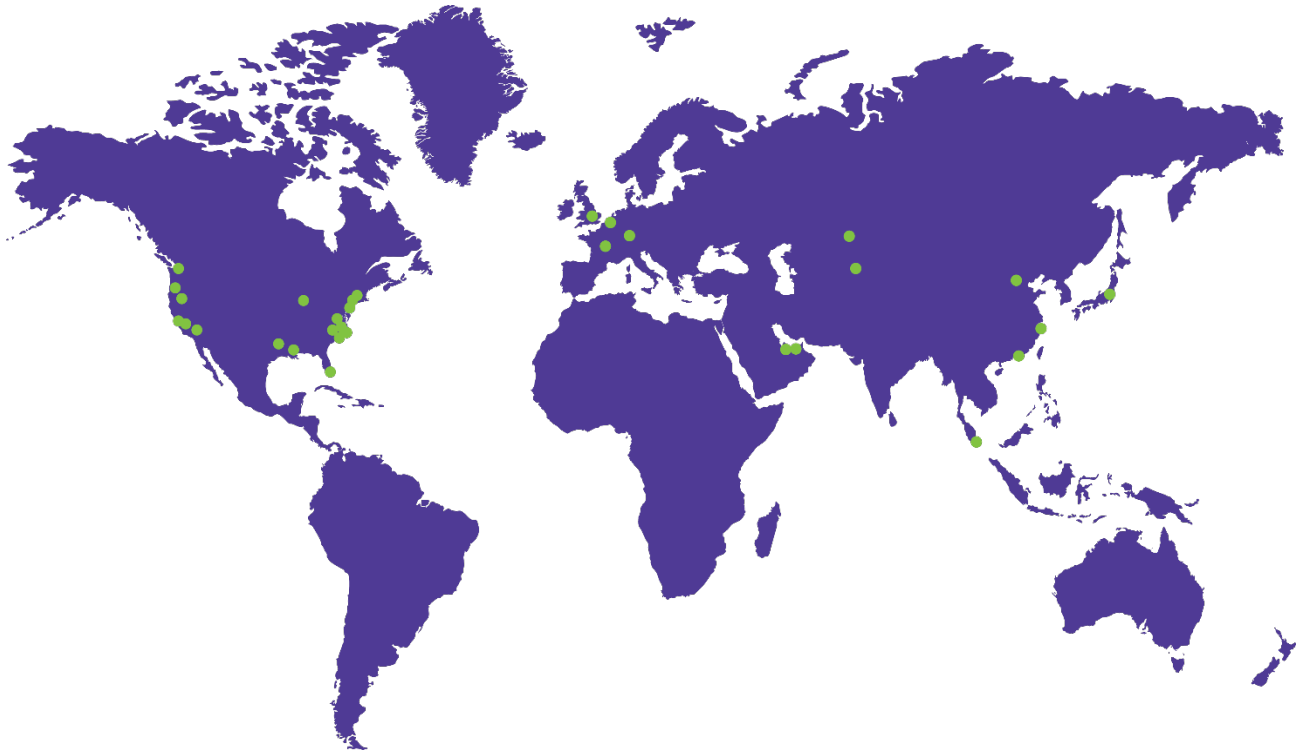

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