

The Steps to a Successful Venture Capital Financing Round

By André Paquette and Valérie Boucher



For the entrepreneur who has no experience with venture capital financing, the process may seem disconcerting, even frustrating. To avoid aggravation that may stem from lack of knowledge or a misunderstanding of this process, we encourage you to take a few moments to familiarize yourself with its various steps. Doing so will spare you many worries.

The entrepreneur who devotes time and efforts to a business project and succeeds in obtaining the capital he needs to start his business, generally from his family and friends (“love money”), inevitably reaches a stage in the growth of his business where capital needs become increasingly larger and he must turn to additional sources of financing.

Traditional financial institutions are usually less than receptive to financing requests from start-up companies that do not yet generate significant revenues and have few tangible assets to offer as security. The entrepreneur is thus left with two avenues: (1) angel investors or (2) institutional venture capital. Angel investors are usually affluent private investors from whose business savvy and networks of contacts a start-up company can benefit.

This bulletin describes the steps involved in a financing round carried out by an entrepreneur who chooses to turn to institutional venture capital from the public or private sector. In this text, the term “investor” designates the venture capital company while the term “corporation” refers to the financing recipient, typically, a corporation incorporated under the *Canada Business Corporations Act* or the *Companies Act* (Québec).

Understanding Venture Capital

Nearly everyone has heard the expression “venture capital”; however, what is it exactly? In most instances, venture capital is, from the investor’s point of view, an unsecured investment in shares, with an investment horizon of three to seven years and the possibility of realizing exponential gains as well as participating in the strategic decisions of the corporation.

The investor that provides the funds does not undertake to act as a passive investor. To the contrary, an entrepreneur who turns to this kind of financing had better be prepared for discussions with the investor and even to justify some of the management decisions he intends to make. The entrepreneur who does not expect – or is not ready to engage in – this kind of dialogue may well encounter frustrations and even fail in his quest for venture capital financing.



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Request for Financial Assistance

Once the entrepreneur understands and accepts the venture capital concept, he is ready to approach one or several potential investors with a request for financial assistance. This request is generally supported by a business plan describing, among other things, the nature of the business and the project for which financing is sought. Some investors also use standard forms to which the entrepreneur must attach various documents (financial statements, budgets, etc.). Without making a lengthy analysis of the business plan, we simply wish to mention that it should supply information on the corporation, such as the identity of its owners and relevant financial data. It should also paint a picture of the corporation's clients, markets, products and services and key persons. The business plan need not be overly detailed, but it should allow the investor to easily and clearly understand the corporation and its project.

Letter of Intent or Conditional Offer

If the corporation's request for financial assistance is positively received, the investor will demonstrate his interest by submitting either a letter of intent or a conditional financing offer.

While confirming the intention to invest under certain conditions, the letter of intent does not constitute a firm commitment that is binding on the investor. It merely sets out the terms of the proposed investment (form of the investment, subscription price, etc.), but is not binding on the investor. The letter of intent is, however, binding on the corporation, once it has agreed to the terms contained therein. The letter of intent can also contain other provisions that may be binding on the investor, the corporation or both and that do not relate to the investment itself. These provisions can include, for instance, exclusivity and confidentiality clauses and provisions granting a right of access to allow the investor to perform a due diligence review.

The conditional financing offer is a firm investment commitment, subject to certain stated terms and conditions specified therein. Numerous conditions may be included in the financing offer, and drafted in a way that allows the investor to opt out if the investment turns out to be less attractive than the business plan had suggested. Some of the conditions that are generally found in conditional financing offers include the confirmation of one or several other investments by other investors, the carrying-out of a due diligence review of the corporation to the satisfaction of the investor, the obtaining by the investor of representations and warranties from the corporation and, possibly, from certain managing shareholders, as well as obtaining from legal counsel to the corporation a legal opinion on one or several issues of interest to the investor.

Since the terms of a letter of intent or a conditional offer are, as a rule, binding on the corporation, it is very important that the entrepreneur ensure that he clearly understands the terms and conditions stated therein and that he consult, without delay and prior to accepting the investor's offer, with legal counsel having extensive experience with venture capital financing. Once the investor has accepted the letter of intent or the financing offer, it may prove very difficult to get the investor to waive its rights thereunder.

Due Diligence

Once the letter of intent or conditional offer has been accepted, the investor will carry out, or cause to be carried out, a due diligence review of the corporation. This process involves a verification of several elements related to the corporation and certain legal, financial or other issues that may impact on the proposed investment. In other words, the due diligence review allows the investor to better evaluate the legal, financial and other risks related to the corporation and to validate certain representations and assumptions made in the business plan submitted by the corporation. The specific elements that are generally examined in the course of the due diligence process include the following:

- the corporation's accounting records and files;
- material contracts;
- intellectual property assets (patents, trademarks, etc.);
- litigation to which the corporation is a party;
- environmental aspects.



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In order to expedite the process and avoid unnecessary and costly loss of time, the corporation should ensure that the documentation to be delivered to the investor or its counsellors for due diligence review purposes is complete, current and in order. It is recommended that the corporation submit this documentation to its own legal counsel beforehand in order to immediately pinpoint any issue that may be raised by the investor and its counsellors and, most importantly, correct any problems. During the course of or after completion of the due diligence process, the investor may suggest or require that certain situations be corrected or clarified, that certain consents be obtained or that certain contracts be entered into.

Negotiation of Final Agreements

In the context of a venture capital financing, two main agreements evidence and confirm the terms of the agreement between the corporation and the investor: the subscription agreement and the shareholders' agreement.

The subscription agreement is similar to a share purchase agreement, except that it is not entered into with an existing shareholder, but rather with the corporation itself. This agreement sets out the form of the subscription (common shares, preferred shares, subscription rights, etc.) and contains numerous representations and warranties by the corporation in favour of the investor, as well as an undertaking to indemnify the investor in the event that a representation or warranty is found to be misleading and prejudicial to the investor.

The shareholders' agreement is a document signed by all the shareholders and the corporation itself. This agreement typically determines the composition of the board of directors, as well as its operating procedure. It contains many clauses that regulate the issuance and transfer of the corporation's shares. The shareholder agreement also contains clauses allowing for the removal of the managing shareholders in certain circumstances, as well as non-competition clauses applicable to these individuals. This document also contains management rights that grant the investor control over strategic decisions of the corporation and withdrawal clauses that allow the investor to withdraw from the corporation by the exercise of sale options under predetermined terms and conditions.

The Closing

Once the final agreements are negotiated, a closing can be held. At the closing, the parties to the transaction sign the related documents and deliver the documents needed to satisfy all conditions for closing the financing. The subscription agreement and the shareholders agreements are signed during this meeting.

A legal opinion of counsel to the corporation is also delivered to the investor at closing. This document certifies to the investor that the securities that are subscribed are validly issued, that the corporation has the legal capacity to enter into the agreements prepared by counsel to the investor, that these agreements have been duly approved by the corporation and that the person signing the documents on behalf of the corporation has the required authority to do so and bind the corporation. The preparation of this legal opinion requires several verifications that counsel to the corporation must carry out, including, among other things, with respect to the constating documents and by-laws of the corporation.

Be Ready!

After reading these pages, you now understand that, for an entrepreneur, the secret to a successful round of venture capital financing lies in adequate preparation and a realistic approach to the investors' expectations and requirements. If you have already started to solicit financing from potential investors or are contemplating such a step in the coming months or even within the next couple of years, it is not too early to obtain legal advice that will spare you nasty surprises at an inopportune moment.

This bulletin is the first of a series of four bulletins on venture capital financing. In the coming months, other members of the firm will address several specific topics related to the subject.

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