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Raising Venture Capital Funding During a Pandemic

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The global spread of Coronavirus Disease 2019 or COVID-19 (the Coronavirus") has resulted in the World Health Organization (WHO) declaring it as a pandemic[1].

Public health and safety are of paramount importance. In addition to impacting global public health, Coronavirus has substantially impacted the global economy including the venture capital and technology ecosystem.

Businesses need to adapt and continue both during the current crisis and to prepare for the eventual upturn once the situation improves. This includes raising capital through venture capital funding.

Below are some themes including some legal issues which we see in the current environment:

DEALS ARE GETTING DONE:

It is not the case that no deals are being consummated. While the travel, leisure and retail sectors have been hit hard by the current situation, venture capital financing rounds have closed and deals have been announced in the last few weeks including in the healthcare[2] and cloud infrastructure spaces[3].

New Sectors Have Emerged

Naturally, there has been renewed interest in the biotech and health care sectors. Coronavirus testing and vaccine development companies have received interest from investors. Given the public health objectives of "social distancing", remote based industries are attracting investor focus. These include telemedicine, online education and entertainment, logistics and delivery services and cloud-based internet infrastructure companies.

Venture Capital Funds have "Dry Powder"

Venture capital funds are sitting on record amounts of "dry powder" having raised over $100 billion over the last few years. Venture capital funds report that they are continuing to evaluate deals[4].

Extended Timelines

Notwithstanding the "dry powder" that venture capital funds have raised, it is important to note that these amounts are limited partner commitments based on capital calls. Limited partners may face their own liquidity issues and therefore deal making may slow down. In addition, there are practical issues around travel restrictions which impact conducting legal and financial due diligence and customer reference checks. Also, in a business which is forged on relationships, in person meetings will now be delayed. All of the above factors will result in deals taking longer to close.

Legal Considerations:

Renegotiated Valuations and Re-trading: Valuations may be impacted by disruptions in business. Investment valuations are typically based on a number of factors including a multiple of revenues, customer traction and other metrics and key performance indicators (KPIs). A re-trade is when an investor or buyer modifies previously agreed terms in a transaction. A typical venture capital financing term sheet is not a legally binding document and is usually subject to further due diligence by the investor on the target company, etc. Even if legally binding transaction documents have been signed, parties may revisit the terms in a re-trade situation.

Force Majeure:

Force majeure is a contractual provision that allows both parties to walk out of a contract when an extraordinary event or circumstance beyond the control of the parties happens. During events such as a pandemic, business may be disrupted. The parties may seek to invoke the doctrine of Force Majeure after a pandemic has been declared in order to extricate themselves from a transaction. The concept of Force Majeure is often incorporated as clause in contracts which serves to release both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties, such as a war, strike, disease/pandemic, etc., prevents one or both parties from fulfilling their obligations under the contract.

Material Adverse Effect:

Material Adverse Effect ("MAE") or Material Adverse Change ("MAC") in a contract is typically defined as an event, condition or change which materially and adversely affects or could reasonably be expected to materially and adversely affect the assets, liabilities, financial results of operations, financial conditions, business or prospects of the company. A MAC clause serves to allocate the risks presented by adverse business or economic developments occurring between the signing and the closing of a merger or acquisition agreement (M&A) or investment agreement. A MAC clause in an agreement may provide a party with the ability to terminate the agreement if events occur which are detrimental to the potential investee company.

Business Continuity:

In light of a pandemic, business continuity becomes critical. Both investors and investee companies need to consider redundancy and business continuity plans including the impact of a pandemic of founders and employees. Investors may insist on key man clauses in investment agreements including requiring the investee company to obtain key man insurance for founders.

Employment Issues:

Companies may implement work from home (WFH) and remote working policies. Companies may consider which employees may work remotely and which employees need to be physically in the office. Disruption of the business may lead to a need to reduce the number of employees and employment laws need to be considered. In addition, employee incentive structures may need to be re-evaluated in the event of employee termination including extending stock option exercise periods.

Closing Conditions:

During the time until closing in an investment agreement, the investee company will usually provide covenants regarding how the business will be operated during that period. This often includes a covenant to continue to operate the business “in the ordinary course”. In light of the current pandemic, an investee company may seek some leeway to operate outside the ordinary course without the buyer’s consent where necessary to deal with disruptions in the business. If representations and warranties have already been provided in the investment agreement, the investee company needs to confirm that it has not inadvertently breached any of them or that they can still be repeated at closing and whether any additional disclosures need to be made.

Commercial Agreements:

Many enterprise customers have delayed the execution of master license agreements and SAAS agreements because of the pandemic. SAAS companies should continue to be vigilant and press forward with customer sales. This includes identifying and keeping in touch with champions in the enterprise. SAAS companies should be pro-active and offer to have its lawyers draft commercial agreements in order to free up the enterprise lawyers for Coronavirus-related matters. Active enterprise contracts help with investee company valuations and cash flows. Offering free trials to potential customers is another potential method to win business as successful free trials may eventually lead to long term master sales agreements.

Going Forward:

The next few months are going to be challenging and uncertain as businesses and the venture capital community adjusts to conditions under the pandemic. However, there will be an eventual end to the pandemic and venture capital backed companies need to understand how to survive the current situation and prepare for the eventual upturn.

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1 Wall Street Journal "Coronavirus Declared Pandemic by World Health Organization", March 11, 2020; https://www.wsj.com/articles/u-s-coronavirus-cases-top-1-000-11583917794

2 Crunchbase "E25 Bio Raises $2m From Khosla Ventures to Create Rapid Covid 19 Diagnostic Test", March 18, 2020; https://news.crunchbase.com/news/e25bio-raises-2m-from-khosla-ventures-to-create-rapid-covid-19-diagnostic-test/

3 Geekwire "Seattle Area Cloud Governance Startup Raises $8.5m", March 17, 2020; https://www.geekwire.com/2020/seattle-area-governance-startup-corestack-raises-8-5m/

4 Axios "Venture Capital Open for Business on Record Amounts of Dry Powder", March 13, 2020; https://www.axios.com/venture-capital-open-business-dry-powder-b78e743b-f47d-42a2-ba17-15c245e13dd3.html

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