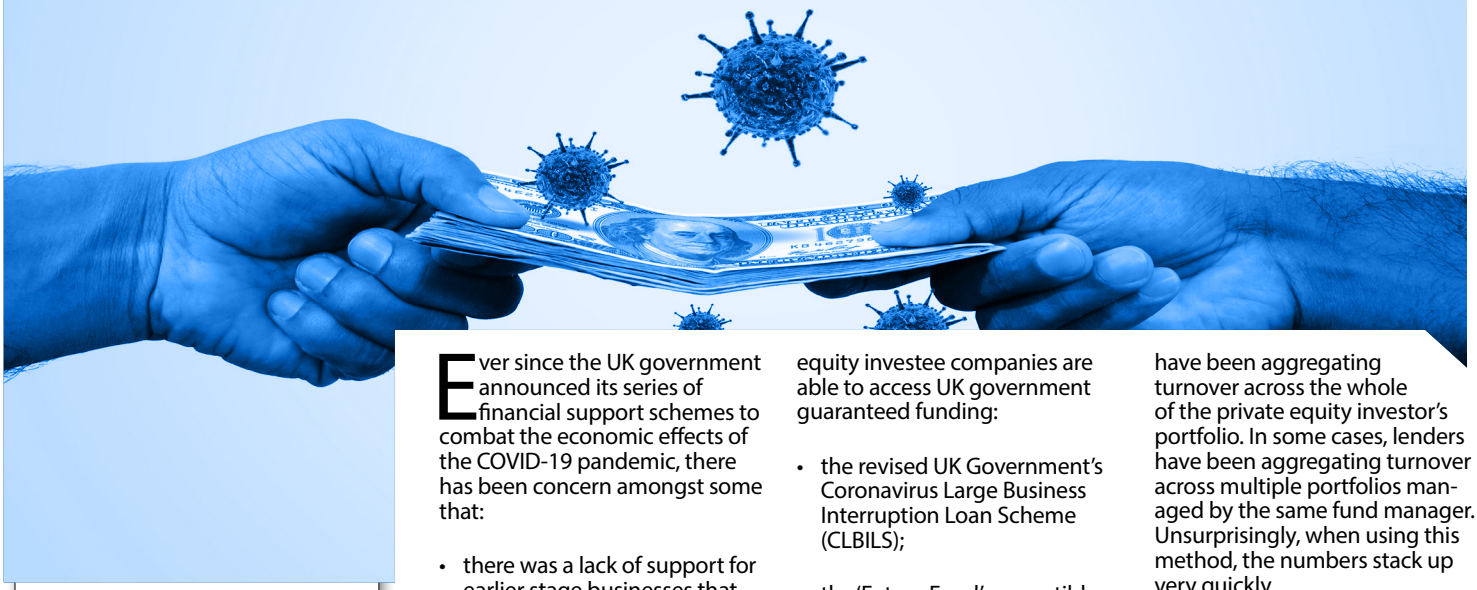
PRIVATE EQUITY AND VENTURE CAPITAL COMMITTEE // Late Spring 2020

PREFERRED RETURNS

PEVC PORTFOLIO COMPANIES GET ACCESS TO UK GOVERNMENT'S COVID-19 LOAN SCHEME



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Ever since the UK government announced its series of financial support schemes to combat the economic effects of the COVID-19 pandemic, there has been concern amongst some that:

- there was a lack of support for earlier stage businesses that may not be eligible for the proposed support schemes; and
- a large number of medium-sized and larger enterprises would fall into a gap between measures and would struggle to access liquidity support.

In particular, the government's Coronavirus Business Interruption Loan Scheme (CBILS) – a key lifeline for SMEs – received a lukewarm reception among venture capital and private equity investors.

Now, further government schemes have been established which potentially change how venture capital and private equity investee companies are able to access UK government guaranteed funding:

- the revised UK Government's Coronavirus Large Business Interruption Loan Scheme (CLBILS);
- the 'Future Fund' convertible loan scheme; and
- an enhanced grant and loan scheme to be delivered via Innovate UK.

In this article, we examine why private equity-backed businesses have so far struggled to access CBILS, and to what extent CLBILS offers hope for those businesses.

CBILS: ACCESS DENIED?

Companies with majority private equity investors on their books have so far been overwhelmingly unsuccessful in accessing CBILS. This is for two principal reasons. First, for the purposes of calculating the applicant's annual turnover (which can be no more than £45 million), many of the approved lenders have been aggregating turnover across the whole of the private equity investor's portfolio. In some cases, lenders have been aggregating turnover across multiple portfolios managed by the same fund manager. Unsurprisingly, when using this method, the numbers stack up very quickly.

Second, according to the guidelines laid down by the Treasury, many private equity backed business are not "viable". In order to qualify for loans, borrowers must have retained earnings on their balance sheets, with no more than 50% of the invested equity eroded by retained losses (in EU State Aid terms, they must not be "undertakings in difficulty"). In many cases, these requirements pose insurmountable hurdles for companies at the early stages of an investment cycle (or "J Curve"), where the company is delivering negative returns but with strong growth prospects. This will include a large proportion of venture capital-backed businesses, which are often pre-revenue.

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PREFERRED RETURNS

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Message from the Chairs

Greetings All!

Who would have predicted that as we planned for the ABA's Spring Business Law meeting in beautiful Boston that the world would be turned on its head? Instead of joining together in person we have been forced to confront a novel virus, macro-economic uncertainty and the related social and emotional implications of these paradigm shifting challenges.

Of course, while we were very sorry to miss you in March, we all agree that the approach to cancel the meeting was absolutely the right action. We hope that you and your family remain healthy and safe.

Our Private Equity and Venture Capital Committee has continued to strive to remain relevant and useful our members. In this vein, with a huge thanks to our editors, Brett Stewart and Emily Cummins, we are publishing this edition of Preferred Returns. Similarly, we are thrilled to announce our brand-new series of webinars – some of which include CLE content - open to all covering venture capital, private equity and several related themes. Our first program is a webinar which is being held on Wednesday, June 3rd focusing on Distressed Private Equity and Other Opportunistic Transactions. Our second webinar is on Friday, June 5th and will be reviewing lessons learned from the recent Delaware Chancery Court case of Palisades Growth Capital II, L.P. v. Alex Bäcker and Ricardo Bäcker and QLess, Inc. No. 2019-0931-JRS (Del. Ch. Mar. 26, 2020).

We encourage you to share details of the webinars with colleagues and friends. Our programs will be speaking to many different constituencies, including younger lawyers as well as regular practitioners of private equity and venture capital who may not attend our meetings in person but whose involvement we welcome and participation via remote attendance is easy.

We've included details in this edition of Preferred Returns about our first few programs. As more programs are scheduled, we'll be sharing details via ABA Connect and the committee's Linkedin Group. Speaking of Linkedin, we would recommend following our Committee's Linkedin page found at www.linkedin.com/company/64528194.

We are pleased to announce that the ABA's Annual Business Law meeting in September will be held virtually! We await more details and you will hear directly from the Business Section Leadership as information becomes available. Our Committee leadership has already started working on ideas for CLE programming and sub-committee meetings, so we will share the exciting content with you during the summer.

Remaining supportive of clients is likely all our top objectives during these unprecedented times and the upcoming period of uncertainty. Please share with us any topics – themes, questions or recommendations - related to Private Equity or Venture Capital that interest you or on which you would like to learn about, both during this unparalleled time and more broadly.

We have multiple avenues of content creation and leadership – from speaking on webinars to writing articles, we have myriad opportunities for you. If you are passionate about writing, we have opportunities for content through our Publications task forces.

Each of the members in leadership volunteered to help this Committee and we regularly collaborate to drive value to you. Please contact anyone listed on page 13 to let us know how you or a colleague would like to be involved. We have roles for everyone: whether you have been practicing law for a few months or having been practicing for many years. Similarly, if you are new to private equity and/or venture capital or a legal luminary in this space…we welcome your ideas, thought leadership and participation!

We hope you enjoy this edition of Preferred Returns and look forward to connecting with you virtually over the coming months!

Best,

Josh Geffon and Steve Wilson

Joshua Geffon
Co-Chair

Steve Wilson
Co-Chair

WE'RE OFFERING SUMMER WEBINARS AND CLES!

Distressed Private Equity and Other Opportunistic Transactions

Wednesday, June 3rd, 2020 | 12:00 PM EST | Webinar

Moderator: Steve Wilson – Osborne Clarke

Speakers:
Elliot Greenstone – Davies
Lisa Stark – K&L Gates
David Albin – Finn, Dixon & Herling
Jonathan Walen – Gibson Dunn
Youmna Salameh & Dan Etessami – Houlihan Lokey

Register here

Agenda:

- Are we now in a buyer's market? Potentially fewer bidders but significant dry powder
- Will we be seeing more share consideration and less "all cash" deals
- Do we have new cross-border issues to consider?
- What are some new trends we expect?
- Government's potential increased role in certain business (intervention, legislation, regulation, direct investments, bail outs)
- Buying local, protectionism and Impact on international trade (agreements)

Founder Coup Averted on Equitable Grounds: The Palisades Case

Friday, June 5th, 2020 | CLE

Moderator: Jon Gworek – Morse, Barnes-Brown & Pendleton, P.C.

Panelists:
Brad Davey – Potter, Anderson & Carroon, LLP
Alyssa Ronan – Potter, Anderson & Carroon, LLP

Register here

Agenda:

Palisades focused on the actions of a former CEO and whether the CEO's efforts to take control were valid actions of the board of directors. The panel will examine lessons leared regarding the formatlities required to properly fill vacant board seats, as well as the equitable principals that formed the basis of the Court's decision to oncluse that the actions taken at the QLESS board of directors meeting were void. As time permits, the panel will also comment on the Court, the company bylaws and the company's certificate of incorporation and coting agreement.

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While some private equity backed businesses are technically able to access the CBILS, meeting the eligibility criteria has been described by the British Venture Capital Association ("BVCA") representatives as like "threading a needle". The BVCA, among other private equity stakeholders and interest groups, have therefore been pressing the Treasury since CBILS's launch to modify its eligibility criteria to acknowledge that companies within a private equity portfolio tend to act independently of each other with no ability to access common resources, and to provide greater flexibility for healthy, growing companies with relatively high debt to equity ratios.

INTRODUCING CLBILS: ACCESS GRANTED?

The launch of the CLBILS has offered a glimmer of hope for private equity investors and their portfolio companies in need of financial support. However, it's clear that some key regulatory and practical impediments remain.

Like CBILS, CLBILS applicants must also:

- be UK-based in their business activity
- have a borrowing proposal which the lender would consider viable, were it not for the current pandemic, and for which the lender believes the provision of finance will enable the business to trade out of any short-term to medium-term difficulty,
- self-certify that they have been adversely impacted by the coronavirus (COVID-19)
- not have received a facility under the Bank of England's Covid Corporate Financing Facility (CCFF) or CBILS.

Unlike CBILS, however, there is no upper limit on the applicant's annual turnover. On the face of it, this appears to address one key obstacle faced by portfolio companies under CBILS, and may open up applications to private equity-backed businesses of all sizes.

CLBILS BASICS

CLBILS applicants can access funding of up to £200 million with the UK Government guaranteeing 80% of this funding. For funding above £250,000, personal guarantees may still be required but the liability of these guarantees cannot exceed 20% of the total funding. It is therefore foreseeable that lenders will require parent entities or subsidiaries of the CLBILS applicants to provide the required guarantees for 20% of the total funding.

The CLBILS funding can take the form of: term loans, revolving credit facilities (including overdrafts), invoice finance or asset finance. The tenor can be from three months to three years. Unlike CBILS, there is no 12 month interest free period or relief from lender-levied fees, so commercial rates of interest will be charged over a maximum repayment term.

The CLBILS funding must not be subordinated to any other senior or super senior obligations.

TURNOVER

To be eligible, the applicant's businesses activities must generate more than 50% of turnover from trading activity and must have turnover of more than £45m per year. It has now been clarified since the initial launch of CLBILS that any company with a private equity or venture capital backer (even where the backer has a dominant stake) will be treated as a separate company for the purposes of assessing turnover. This means this if the individual company's turnover is below £45m they should be eligible for CBILS. If the individual company has a turnover over £45m they should meet this eligibility limb for CLBILS.

POTENTIAL ISSUES WITH CLBILS

LENDER DISCRETION

Crucially, the UK government has ceded power to the lenders to determine eligibility to the CLBILS. Most are likely to take a cautious approach to making such a determination, especially during the infancy of the scheme, which is likely to cause a bottleneck of applicants waiting for approval. Lenders are positively looking at ways to support private equity portfolio companies through UK government schemes, but there are many conditions to meet and these conditions are still being explored on a case-by-case basis. A challenge for lenders is that they do not know that the 80% UK government guarantee is valid until it comes to time to make a claim and unless the CLBILS guidelines are very clear, lenders cannot be sure whether they are taking 20% or a 100% risk for their liability management purposes and risk assessment.

Another issue is that the CLBILS fails to use the participating lender as a pass-through agent for the UK government, but instead leaves the lender: (a) to do the credit assessment and (b) with credit risk (albeit this risk is limited to 20%). The quantity of demand for the CLBILS, plus the pre-existing debt/security that applies to most sponsor-backed companies, means that in practice the existing lender for the applicant is the only option and is being asked do a credit assessment on the applicant at a time when doing so is operationally and technically difficult.

There is also a fundamental point that an applicant's existing lender (especially if not a UK clearing bank) may not be a registered and approved lender for the CLBILS. If so, access to the funding will not be forthcoming without engaging a new lender which would present intercreditor relationship issues. Any existing lender that is not an approved CLBILS lender would be concerned that such UK Government backed funding, if utilised by a borrower, might prejudice their credit position given that a CLBILS loan would need to be senior to any existing debt. Therefore, some existing lenders (in particular direct lending funds) may consider amending existing terms, seeking fees or resetting interest rates before providing their consent to such funding coming into the debt structure, if such consent is required under the loan documentation.

IMPLEMENTATION

The lender's credit assessment is further complicated by the fact that the CLBILS is to be superimposed on a pre-existing debt structure of the applicant. In some cases, lenders may find it easier to help existing customers by way of conventional channels and increased flexibility under existing documentation though execution of short-term waivers.

In addition, the CLBILS loans (being bilateral and typically based on standard form documents) are likely to be difficult to dovetail with Loan Market Association (LMA) based facilities. We have already seen this tested on CBILS funding that we are putting in place for clients who have LMA-based facilities and so are able to transfer lessons learnt to the implementation of CLBILS funding.

TIMING

There is also a question for private equity investors around whether now is the right time to access the CLBILS funding or whether such funding would be better accessed once the lockdown restrictions are lifted and businesses are seeking to return to normal. Accessing the CLBILS now would not only result in incurring fees and interest accruing, but would also result in them being at the vanguard of the negotiation of the types of restrictive terms that lenders are offering as part of the CLBILS financing. Private equity investors will likely want to have a better understanding of what terms lenders are attaching to the CLBILS financing packages, especially when access to the CLBILS is not absolutely necessary. Instead, immediate relief for private equity backed businesses has come by obtaining HMRC approving deferrals to corporation tax, VAT and even PAYE payments.

Our expectation is that the bulk of new money requests will come in a couple of months, or even further down the line. This is when a possible liquidity crunch is anticipated for those businesses that have successfully managed their cost base to date, but which subsequently have to meet the cost of kick starting their business again at a time when they've already collected all cash and reduced debtors.

VIABLE BUSINESSES?

While portfolio companies may now be able to get around the turnover requirement under CBILS, this will not change the ratios on their balance sheets, and it seems likely that many applicants will be rejected as "undertakings in difficult" on the same grounds as under CBILS. This is largely due to the prevalent use of shareholder loan notes in acquisition funding structures which can result in a private equity backed business falling foul of the relevant EU State Aid rules from which the CLBILS viability test in part originates. Private equity lobby groups have been advocating for a relaxation to this viable business eligibility limb which is also affecting other lossmaking companies outside of the private equity space accessing CLBILS.

LIFE SCIENCE AND THE BUSINESS OF DATA PRIVACY

by Patrick McKnight, Associate, Klehr Harrison Harvey Branzburg LLP

The digital revolution is creating terabytes of valuable data. This information helps life science companies produce remarkable innovations and present outstanding investment opportunities for private equity firms. Deals in the life sciences space have increased as healthcare, pharma, biotech, and medical device companies continue to flourish. With this growth comes an unprecedented emphasis on cybersecurity and data privacy compliance.

HIPAA COMPLIANCE IN LIFE SCIENCE

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") remains the most important privacy law in the life sciences. The HIPAA Privacy Rule regulates potential disclosures of Protected Health Information (PHI) by covered entities. The Security Rule requires administrative, technical, and physical safeguards to protect Electronic Protected Health Information ("EPHI"). Important updates were passed in 2013 extending regulations beyond covered entities to also reach the activities of "business associates."

HIPAA violations can result in expensive fines, settlements, and even criminal indictments. In 2018, the Health & Human Services Office for Civil Rights levied a record amount of HIPAA-related fines, totaling nearly $29 million. In 2017, Memorial Healthcare Systems received a record $5.5 million fine for accessing the confidential information of over 100,000 patients. In 2010, Cignet Health received a $4.3 million fine for failing to honor patients' requests for copies of their own records. Although criminal indictments are less common, the law does provide for criminal penalties of up to 10 years in prison.

Small, fast-growing companies are often the most at-risk for compliance issues. HIPAA compliance should be part of the due diligence process for savvy private equity and venture capital firms. Contracts, procedures, data security, and any past instances of breached information all deserve close scrutiny.

Patrick McKnight
Associate, Klehr Harrison Harvey Branzburg LLP

THE CCPA ERA BEGINS

On January 1, 2020 the California Consumer Privacy Act (CCPA) went into effect. The CCPA is the most comprehensive data privacy legislation enacted in the United States thus far. The law applies to all companies doing business in California which either have over $25 million in revenue, generate at least 50% of their annual revenue from selling consumer's personal information, or buy, sell, receive, or share the personal information of over 50,000 consumers.

The CCPA is drafted broadly to cover the "personal information" of "consumers."

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A "consumer" is defined as any natural person residing in California. "Personal information" includes any information which could reasonably be linked to an individual consumer.

The CCPA includes important exceptions for health care data. In particular, personal information covered by existing federal and state laws is exempted. This includes information covered by HIPAA and the California Confidentiality of Medical Information Act. The CCPA specifically exempts covered entities which "maintain patient information in the same manner as medical information or protected health information." The problem is "patient information" is never defined. The CCPA also exempts certain forms of clinical research, but again the lack of precise drafting language leaves significant uncertainty regarding the exact extent.

Several amendments to the CCPA were enacted in late 2019. These amendments attempted to clarify the scope of the law. The new amendments exempt businesses from protecting the personal information of employees, applicants, and contractors. This temporary measure gives the California legislature one year to enact a separate privacy bill focusing exclusively on the rights of employees. Another potentially important clarification coming out of the new amendments is the definition of "personal information." It now seems clear personal information does not include de-identified or aggregate consumer information. Another proposal introduced in January 2020 seeks to expand the HIPPAA exemption.

Violations of the CCPA are enforceable by the California Attorney General by fines of up to $7,500 per violation. The law also provides consumers a private cause of action.

LIFE SCIENCE COMPANIES AND CYBERSECURITY

Life science companies are a prime target for hackers. Ransomware, phishing, and attacks on weak passwords have become increasingly common. According to the Chubb Cyber Index, cyber incidents relating to healthcare grew at an incredible 2390% from 2009 to 2017. Health information can be more valuable to hackers than payment information like credit cards. Not surprisingly, health care constituted 38% of all cyber insurance claims over the last decade, the most of any industry.

Cybersecurity threats are a fact of life in the modern business world. Individuals, law firms, companies, and even courts have made headlines by falling prey to sophisticated cybersecurity attacks. Not surprisingly, cybersecurity is now widely recognized as relevant when structuring deals. Like #MeToo reps, cybersecurity is another risk a buyer can no longer afford to ignore. The ABA's 2019 Private Target study found 68% of deals had a privacy representation. 70% had a cybersecurity representation. This indicates awareness of cybersecurity risks is expanding but has yet to become standard operating procedure.

Part of what makes cyber threats unique is they regularly go undetected for months or even years after a deal is closed. While reps addressing cyber incidents are becoming more common, they may not always be sufficient. A thorough due diligence of the target's cybersecurity infrastructure, policies, procedures, and any past breaches is indispensable. Representation and warranty insurance and/or cybersecurity insurance can also be helpful.

Conclusion: What Are the Implications for Private Equity and Venture Capital?

Attorneys cannot prevent all regulatory or cybersecurity problems for their clients. But assisting private equity investors identify potential problems before a deal is finalized is a crucial best practice.

Data is one of the most valuable assets for emerging life science companies. A lack of regulatory compliance and data security can become one of its greatest liabilities. Sophisticated private equity clients should make data privacy part of their due diligence process to manage risk and identify opportunities for growth.

An Interview with Martha Miller,

Director of the U.S. Securities and Exchance Commission's Office of the Advocate for Small Business Capital Formation

Martha Miller was named the U.S. Securities and Exchange Commission's first Director of the Office of the Small Business Capital Formation in December 2018, leading the new office created by the SEC Small Business Advocate Act of 2016.

We are honored to have Director Miller and her Office joining our PEVC Committee's initiatives. This interview is part of our Committee's efforts to introduce Director Miller and her Office's projects to our membership.

Director Miller, please tell us a bit about yourself?

Thank you so much for inviting me to share a bit about myself and our "start-up" office within the government. If the readers were listening to rather than reading this interview, they would pick up on my southern accent, a byproduct of my Alabama roots. I grew up surrounded by multi-generation entrepreneurs who taught me the power of building something to provide for themselves, their families, and their communities. Prior to joining the SEC in January 2019, I was a partner at the law firm of Balch & Bingham LLP in Birmingham, Alabama, where, like many of your members, I represented companies and investors across a spectrum of corporate transactions. I used to joke when people asked what kind of law I practiced that I was a "business therapist"—something that may ring true to many of you who know well that in the course of closing deals, managing diligence, and bridging major transitions,

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you work on problem-solving in every aspect of the business, the most important one being the people.

What is the mission of the SEC's new Office of the Advocate for Small Business Capital Formation?

Let's start with the obvious statement: businesses need capital to build, grow, and thrive, whether that is capital from self-financing, retained earnings, lenders, or investors. Entrepreneurs are increasingly looking to investors to support their needs, but the path to equity is not easy for everyone (despite what some headlines may say). Our Office was created by Congress through bipartisan legislation to advocate for small businesses and their investors—from start-ups to small cap public companies—to foster better access to capital markets, strengthening the voice of small business within the SEC and the broader regulatory landscape. Put simply: we work to improve the toolkit for raising capital. We do that by focusing on practical, market-driven solutions developed through outreach and engagement with diverse audiences across the country and stages of capital raising, and by engaging closely behind the scenes to provide feedback early in the rulemaking process. In an effort to engage more voices in the rulemaking process, we started creating capsule videos summarizing SEC proposals, a first for our agency. I think we have the most exciting job at the SEC (granted that I am biased), because we're working in such a dynamic area. Our entire team is passionate about what we do and the people we are supporting, and it shows in the approach we bring.

Can you help us understand the problems small businesses have with securing access to capital?

Depending on what type of capital is being raised—from initial seed funds, to growth or mature institutional equity, to capital from public investors—we hear a variety of issues across the spectrum. Those issues are often exacerbated for women-owned and minority-owned businesses, as well as businesses located in rural areas or areas affected by natural disasters, all populations we are focused on supporting. Over our first year, we met with hundreds of entrepreneurs, founders, investors, advisors, and thought leaders who told us firsthand about the issues they face. Our team knows the importance of both the qualitative experiences and the quantitative data, weaving both together in our inaugural report, which contains a 27-page dive into the state of capital formation, broken down by life cycle stage, demographics, and offering type. If you are expecting a Times New Roman treatise when you hear "government report," then please click the link to be surprised. We wanted to create an engaging, visual depiction of what is happening with capital raising to inform the discussion and to contextualize the report's policy recommendations, which cover modernizing, clarifying and harmonizing the exempt offering framework; investor participation in private offerings; engaging investors via finders; crowdfunding; and scaled obligations for smaller, less complex reporting companies.

How does your Office advocate for policy solutions that encourage capital formation?

I have always loved President Truman's quote: "It is amazing what you can accomplish if you do not care who gets the credit." Practicing law, I was almost always out of the spotlight after closing (more accurately: in front of a laptop in a conference room with a stack of marked-up drafts and empty coffee cups). Sound familiar?

Our Office brings a philosophy similar to President Truman's: we want the best possible outcome for businesses and their investors to thrive. We do that by collaborating with colleagues across the agency and beyond to make sure the Commission has the best possible input that reflects the market needs as early as we can provide it. Or to put it in deal terms: we try to influence the term sheet development, not the final purchase agreement once the terms are set. We are not looking for credit. We focus on outcomes and getting the word out to affected and interested constituents.

Even though you didn't ask about specific rulemakings with this question, I would be remiss if I did not highlight the Capital Formation Proposal that the Commission published for comment, which seeks to reduce areas of friction in the exempt offering framework that companies rely on to raise early stage capital, as well as capital to prepare to one day go public.

Some of the topics covered in the proposal include:

- increasing offering limits for Regulation Crowdfunding, Rule 504, and Regulation A;
- harmonizing disclosures that are provided to investors, including aligning the Rule 506(b) non-accredited investor financial disclosure requirements with Regulation A;
- providing new pathways to test-the-waters and a new exemption from general solicitation for demo days;
- permitting crowdfunding special purpose vehicles; and
- defining and clarifying integration.

I hope that your readers will comment on the proposal and engage with our office. We would love to hear from you, whether in person, by phone or electronically.

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VALUATION IN PRIVATE EQUITY

VALUATION OF COMPLEX CAPITAL STRUCTURES OF VENTURE CAPITAL AND PRIVATE EQUITY INVESTEES

In 2019, investment in venture capital exceeded 10,700 transactions constituting $136 billion, which exceeded 2018's record 10,500 transactions, but fell slightly short of 2018's record $142 billion in investments[1]. The trend in venture funding indicates that there are numerous companies under development with compelling business plans to solve problems or challenge industry norms. These investments made by both Venture Capital and Private Equity firms create a need to establish equity valuations for tax and financial reporting purposes. The following sections discuss the different types of equity instruments that are commonly used in capital funding and how they are valued.

COMMON STOCK

Common stock is a security that represents ownership of a corporation. Other forms of entities (LLC's) may use units instead of shares, but they still represent ownership interests. Common stock is generally held by founders, management and employees. Some companies issue options that convert to common stock as a form of compensation to employees. Common stock typically has voting rights, although some entities may have voting stock and non-voting stock.

PREFERRED STOCK

Venture capital ("VC") and private equity ("PE") investors typically receive preferred stock, which is senior to common stock and has certain debt-like features. There is not a standard form of preferred stock, but most issuances have at least some of the following key economic features:

- Liquidation preference
- Dividends
- Conversion option to common stock
- Participation rights and caps
- Seniority or pari passu relative to other classes of preferred shares

A liquidation preference provides a safety net in a liquidation or a liquidity event, in which the preferred stock investor must receive their liquidation preference before common stock receives proceeds, and in some cases before other preferred shares depending on the seniority.

Dividends are often a key economic element of preferred stock and generally accrue over time as entities typically do not have capital to pay cash dividends. In some cases, the accrued dividends accumulate and increase the payoff to the preferred at a liquidity event, which can have the effect of reducing the value of the common equity and other subordinate equity securities. Often, dividends are non-cumulative, such that if they are not paid for a particular period, that dividend is foregone.

The conversion option is perhaps the most valuable economic benefit of "convertible" preferred stock. Not all preferred stock has this option, though it is typical in VC and PE investments. The conversion option enables the holder to retain the preferred and its benefits (preference), or convert to common stock presumably after the common value exceeds the price at which it would be more economically beneficial than to retain preferred shares. For example, if a preferred share has a liquidation preference of $5.00 but the value of common is $7.50, the preferred share owner may choose to forego the liquidation preference and other features and convert to common in order to maximize its investment.

Participation rights entitle the holder to not only its liquidation preference, but also a share of proceeds with common stock beyond that. If participation is part of the agreement, it is generally capped at 2 to 3 times the initial preferred per share price.

Seniority or pari passu relates to the order of payout for each class of preferred stock. Often preferred stock is treated as pari passu, or equal to each other in terms of sharing proceeds of a liquidity event based on the relative number of shares owned. In cases where a certain class has seniority, holders of that security would be paid out in full before the other classes receive a payoff.

WHEN DO COMPANIES NEED VALUATIONS?

When companies grant equity to employees, or when VC and PE investors issue financial statements, companies are required to record the expense of the grants on their Income Statement (ASC 718[2]) and VC and PE investors record the fair value of their investments under fair value accounting guidance (ASC 820). In addition, and a more immediate concern if the company does not have audited financial statements, is that the strike price of the stock options granted cannot be lower than the fair market value of the underlying security at the time of grant, per Internal Revenue Code Section 409(a), or the difference is taxable as income to the recipient of the option grant. Common practice is for companies to get an independent valuation at least once a year, unless a material event occurs, such as a new round of

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financing or an economic event, which may require an updated valuation. This valuation is then used to "price" shares or options issued over the next twelve months. Companies that are more mature and heading towards an IPO often update valuations more frequently (e.g., quarterly) based on grant volume to document the ramp up of the company value.

HOW IS PREFERRED AND COMMON STOCK VALUED?

The valuation of entities with complex capital structures requires the use of fairly advanced techniques to allocate the overall equity of the company to the different equity classes. The first step is to estimate the fair market value of the total equity. In general, the discounted cash flow method, guideline public company method, and guideline transactions method are the primary methods to value a business. In the event that a company recently obtained a new round of financing, it is possible to infer the value of the total equity using the details from the new round (known as a backsolve method).

Once the total equity value is established, the fair market value of the common stock must be estimated as that is the basis of new stock or option grants. In a complex capital structure, there are three primary methods that are used to allocate the total equity value to each of the classes of equity: Option Pricing Method ("OPM"), Probability Weighted Expected Returns Method ("PWERM"), and the Current Value Method ("CVM"). In some cases, a hybrid method is required. The core information that is used to develop the allocation models include the latest capitalization table and the Certificate of Incorporation or the Operating Agreement, which generally describe the terms of the preferred and common stock.

The OPM method uses a series of Black-Scholes-Merton call option models to allocate the total equity value. Essentially, the OPM treats each strip of capital as a call option on the overall equity value and allocates value based on the determination of breakpoints, or the points where the equity value reaches a payoff for a certain class of equity. For example, a breakpoint would be the dollar amount of a preferred liquidation preference, or the per share price where a preferred class would convert to common equity.

In addition to the total equity value and the breakpoints, the other key inputs to the OPM are a) time frame until an expected liquidity event; b) risk free rate corresponding to the time frame; and c) the volatility of the underlying stock, which for private companies is typically based on peer company volatility, also over the corresponding time frame.

The CVM is typically only used when there is an imminent liquidity event. In general, the CVM allocates value through a waterfall of the proceeds from an expected transaction (merger, IPO, etc.). The waterfall would follow the seniority of the securities as described in the Certificate of Incorporation or the Operating Agreement.

The PWERM method uses a selection of potential future outcomes for the business such as an IPO[3], a merger, a future financing round, or the dissolution of the entity. The key inputs to the PWERM include a) identifying each scenario; b) the value of the company under each scenario; c) the timing of the scenario; and d) the probability of each scenario. In most cases a waterfall method similar to the CVM is used at the liquidity event and the individual equity class values are then discounted to present value.

A hybrid method might join the PWERM and the OPM together to measure different scenarios. For example, a company that is in the IPO process may look at the probability of the IPO value established by its investment bankers and the probability of a stay private scenario using an OPM.

OPTIONS

Options are typically issued at fair market value for tax purposes or at fair value for financial reporting purposes. Yet, in general, there is not a material difference in the two definitions that would equate to a price difference. In most cases, options are convertible into common stock or units. In some cases, the options may have performance or market conditions such as exceeding a revenue or EBITDA target or exceeding peer group performance measures. In those cases, other analytical models such as Monte Carlo simulations or binomial lattice models are typically used instead of the OPM[4].

OTHER INFORMATION

There are a number of publications on this topic including the AICPA's recently-issued guide titled *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies.*

COMMON PROBLEMS TO AVOID

Preferred stock is a superior security to common stock. That said, there are instances where companies use a recent preferred stock capital raise as the basis for the common stock by using the same price. These are two different securities and even with a featureless preferred stock, it has the liquidation preference and seniority that common does not. Using an overvalued common price can create problems down the road when future grants are made, and the valuation analysis indicates a significant decrease in the common value. This is bad for employees and painful to reverse.

It is important to use a valuation solely for the purpose it was prepared. For example, it would be inappropriate to use the per share value based on a goodwill impairment valuation for an option grant as the valuation was prepared for a controlling interest basis and the basis for options would be minority, non-marketable. Misuse of a valuation can cause errors in accounting and tax.

SUMMARY

Overall, capital structures with multiple classes of stock like those described here are generally complicated to value. It is important for VC and PE firms, companies and their counsel to make sure that the independent valuation firm has the appropriate level of experience with both early stage companies and the available valuation techniques in order to prepare reasonable valuation conclusions that do not draw excess audit or taxing authority scrutiny.

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Managing Director, CFGI, LLC

Endnotes

1 Source: Pitchbook Venture Monitor 4Q 2019

2 Accounting Standards Codification 718 – Share-Based Payments and ASC 820 – Fair Value Measurements are issued by the Financial Accounting Standards Board.

3 For an IPO scenario to be used, the entity should be in the IPO process and have initial pricing from the investment banks.

4 An OPM with Black -Scholes, a Monte Carlo simulation and a binomial lattice model will all give the exact same result with the same inputs. Where the Monte Carlo and binomial come into play is when there are path dependent conditions that cannot be captured in a closed form model like Black-Scholes.

INVESTING IN CANNABIS: CANADA CANNABIS 3.0

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The recent legalization of adult-use cannabis in Canada has created a hotbed of new commercial opportunities. Cannabis 1.0 introduced initial classes of cannabis products for adult recreational use alongside the existing medical cannabis regime. One year later, Cannabis 2.0 legalized new cannabis classes, including the much-anticipated cannabis edibles, topicals and extracts. Industry and Canadians are anticipating the next wave of cannabis products. It is anticipated that Cannabis 3.0 will bring cannabis drugs and other therapeutic products, opening a new market for industry and a huge opportunity for new investment in Canadian cannabis.

Adult-use, recreational cannabis was first legalized in Canada on October 17, 2018. At that time, the Cannabis Act and Cannabis Regulations permitted the cultivation, manufacture and sale of five classes of cannabis products: fresh cannabis, cannabis plants, cannabis plant seeds, dried cannabis and cannabis oil. Cannabis 2.0 kicked off in October 2019, with amendments to the Cannabis Act and Regulations authorizing the sale of three additional classes of cannabis products: cannabis edibles, cannabis topicals and cannabis extracts.

The regime authorizing cannabis for medical purposes that was formerly in place under the Controlled Drugs and Substances Act remains, and registered clients of licensed producers continue to obtain cannabis for medical purposes directly from their authorized producer. However, no cannabis product (even cannabis sold for medical purposes to an individual who has received medical authorization) can be marketed or sold with an associated health or therapeutic claim.

Despite the significant chatter about the medicinal properties of the plant, the Canadian regime does not (at present) permit any of the permitted classes of cannabis products to be marketed with health or wellness claims. As a result, Canadians do not currently have access to cannabis products labelled for therapeutic purposes.

The Regulations legalizing recreational cannabis also introduced a licence for the manufacture and sale of "cannabis drugs", defined as a drug containing cannabis. For the purpose of this discussion, "drug" is defined in the Cannabis Regulations as meaning any substance or mixture of substances represented for use in diagnosis, treatment, mitigation or prevention of disease, disorder or abnormal physical state or its symptoms in human beings or animals, or restoring, correcting or modifying organic functions in human beings or animals.

In addition, when the Cannabis Act and Regulations came into force, all of the phytocannabinoids produced by, or found in, the cannabis plant (or synthetic equivalents thereof) were included on Health Canada's Prescription Drug List. As such, all cannabis drugs are currently regulated as prescription drugs. Cannabis drugs are subject to the rules and requirements of the Food and Drug Regulations, including the pre-market authorization requirements which necessitate (among other things) the undertaking of clinical trials to demonstrate safety and efficacy of the drug for its proposed use. Given the infancy of the Canadian cannabis regime, and the relatively high barriers to entry impose by the Food and Drug Regulations, we have seen very little activity in the cannabis drug space.

However, despite the initial barriers to entry, cannabis drugs represent a significant opportunity for companies with cannabis

>> Continued on Page 11

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and/or pharmaceutical experience and an appetite for investment. The market for therapeutic products containing cannabis will undoubtedly be a robust one, and there are first-mover opportunities for those willing to take the plunge. While the drug regulatory submission and approval process is neither simple nor short, it does result in (if successful) market authorization of a new drug and, particularly in the cannabis space, access to an entirely new Canadian market.

Anyone with sights on investing in the Canadian therapeutic cannabis industry should also be mindful of recent initiatives around reducing the regulatory burden for approval of cannabis health products containing CBD with little or no THC. Industry is lobbying Health Canada to remove CBD from the Prescription Drug List and to create a pathway for the approval of cannabis health products, outside of the Food and Drug Regulations.

The Natural Health Products Regulations, which are also made under the Canadian Food and Drugs Act, create a pathway to market for naturally sourced drugs. Approval of such products requires the filing of a regulatory submission demonstrating safety, efficacy and quality of the proposed product however, unlike the drug approval pathway, these requirements are designed for approval of natural products which are not necessarily standardized like traditional chemical compounds that are manufactured in a lab. Industry has long believed that this pathway is far better suited to the approval of therapeutic products containing cannabis. Health Canada issued a stakeholder consultation on a new regulatory pathway for cannabis health products but to-date we have not seen any movement towards finalizing a new regime.

THERE EXIST EXCITING OPPORTUNITIES FOR INVESTORS IN THE THERAPEUTIC CANNABIS SPACE

Despite the challenges that the current regulatory regime presents and the uncertainty around a new pathway for cannabis health products, there exist exciting opportunities for investors in the therapeutic cannabis space. Once a cannabis drug is approved, it will have significant market advantages over currently-available cannabis products, which cannot be marketed with any therapeutic or wellness claims and are otherwise subject to very strict restrictions on promotion.

Approval by Health Canada allows for marketing and other promotional activities. These activities will be limited by the requirements of the Food and Drugs Act and Regulations, however promotion in conjunction with a health claim and promotion outside of strict age-gated environments (which are each currently prohibited) will be possible. In addition, whereas currently available cannabis products can only be accessed through provincial cannabis retailers, or in the cases of cannabis for medical purposes, directly from a licensed producer by a registered patient, cannabis drugs will be available through pharmacies, with a prescription. If lobbying efforts are successful and the natural health product pathway becomes available for cannabis health products, these may be available through pharmacy without a prescription, and possibly other retail outlets.

Although investment in the Canadian cannabis industry may have slowed in recent months as we settle into Cannabis 1.0 and 2.0, there is still room for early-mover advantages in the case of Cannabis 3.0. The upcoming therapeutic cannabis industry will undoubtedly be significant, with large potential upside for those who invest.

COMMITTEE HIGHLIGHTS

Fall 2020 Annual Meeting

The same great content, in a more convenient format!

The Fall 2020 Annual Meeting has moved online, and will take place the week of September 21-25, 2020. The Private Equity and Venture Capital Committee Leadership are working to make sure that all of the same content you know and love will be included in the online meeting. We look forward to seeing you all there and will provide further updates on programming. In the mean time, be sure to check out the Covid-19 focused CLE content the Private Equity and Venture Capital Committee will be presenting this summer. We hope you all stay well through this time and will see you in September!

WE'RE ON SOCIAL MEDIA

We have launched a new and improved LinkedIn page to facilitate a more interactive experience. It's the best source of updated Committee information to stay current on the Committee and our activities. Please follow us there @ https://www.linkedin.com/company/aba-private-equity-and-venture-capital-committee

JUDICIAL DEVELOPMENTS

Members of the committee are reminded to be sure to read the Annual Survey of Judicial Developments Pertaining to Private Equity and Venture Capital in the most recent ABA Business Law Section Business Lawyer magazine. The survey is required reading to ensure you are on top of the latest judicial developments that can impact your clients and the drafting of legal documents. Special credit belongs to the Working Group of our Jurisprudence Subcommittee: Lisa Stark, Thomas A. Mullen, Lisa Hedrick, Annette Becker, Frank Mazzucco, Scott Bleier, Jacqueline Brooks, Jordan A. Simko, the Honorable Meghan A. Adams and Alberto Chavez. The survey is available here

THE BEST OF

BOSTON

JUST BECAUSE WE MISSED THE MEETING DOESN'T MEAN WE HAVE TO MISS OUT ON WHAT BOSTON HAS TO OFFER. SOME OF THE BEST OF BOSTON CAN BE ENJOYED FROM A SOCIAL DISTANCE:

1. Best Virtual Art Collection– The Harvard Art Museum is offering on-line tours and talks about its collection. Check it out at https://www.harvardartmuseums.org/article/harvard-art-museums-from-home

2. Best Italian – Locals and tourists alike know that SRV in the City's South End is known for fabulous pasta. Chef Michael Lombardi shared the recipe for 'SRV's Tajarin' so everyone can recreate this memorable dish at home.

3. Best Work Out – Missing the gym? Proud Bostonian (and F45 investor) Mark Wahlberg invites followers to work out along with him on his Instagram live feed https://www.instagram.com/markwahlberg/?hl=en

4. Best Virtual Tourist – For many a trip to Boston isn't complete without a visit to the New England Aquarium. While it's currently closed to visitors, virtual visits and presentations are posted to its Facebook page daily @ 11am (EST).

5. Best Shopping – You can enjoy and support many of Boston's favorite local boutiques from the comfort of your own home. Here are a few favorites for your to check out: for a collection of women's accessories, fine and fashion jewelry and ready-to-wear clothing try Copious Row; for upscale streetwear and shoes take a look at Bodega ; and for New England's best modern crafts and artisanal products you can set up a personal virtual shopping appointment at Good by calling 617.722.9200.

6. Best Podcast: What would podcasts be without Boston's own NPR? Among it's many offerings, NPR is offering a curated playlist of podcasts designed to help you keep busy and manage anxiety through the pandemic

7. Best Lobster Roll: Lobster rolls go hand-in-hand with summertime in Maine. Those of you who are local can still enjoy the delicacy in your own home by picking up a Lobster Roll Kit from Row 34; those too far away for local pick up can find the Food Network's recipe for Maine Style Lobster Rolls here.

8. Best Cocktail: With bars closed and virtual happy hours becoming the norm some of Boston's best bartenders have shared recipes for cocktails to be made at home https://www.bostonmagazine.com/restaurants/2020/03/23/bartenders-funds-at-home-cocktail-recipes/.

9. Best Live Music: Whether you are in Boston or elsewhere we know everyone is missing live music, for an updated list of current podcasts and live streaming events that can be enjoyed anywhere check out https://www.billboard.com/articles/columns/pop/9335531/coronavirus-quarantine-music-events-online-streams.

10. Most Unusual Museum: While the museums themselves remain closed, online tours of the Salem Which Trial Sites allows you to investigate many of the sites from the comfort of your own home .

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NEXT MEETING

Business Law Section
2020 Annual Meeting

September 21-25, 2020

Online

ARTICLES & AUTHORS NEEDED

The Committee is collecting articles for future newsletters which are circulated to our members worldwide.
Please send your submissions to Brett Stewart at brett.stewart@mcmillan.ca

Articles should be 1500 words or less, and on any topic of interest to practitioners in the private equity and venture capital sectors. From short scholarly articles, to practice tips, reviews/summaries of a Section program, life in the trenches, interesting pro bono projects, humorous looks at life and the law, or even how you balance work and personal life. We appreciate your help in making this newsletter a success.

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