The Risketta Stone: How family offices can better manage their cross-border venture and growth capital investment risks

FAMILY OFFICE AND HIGH NET WORTH

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Businesspeople speak in terms of risks and rewards, not warranties and indemnities. This explains why family office professionals, when reviewing investment and shareholders' agreements, often feel like they are reading hieroglyphics. It also suggests the need for a legal version of the Rosetta stone, the slate that showed hieroglyphics side-by-side with Greek, helping scholars decode the distinct characters comprising Egypt's formal writing system.

Below we offer the lawyer's equivalent of the Rosetta Stone for cross-border venture and growth capital transactions – a "Risketta Stone" – to help you understand the legal jargon surrounding common investor protections and the risks they are intended to address

Risks not known at the time of investment *Translation: Warranties*

Investors use warranties to flush out risks not disclosed by the company during due diligence. They are statements about the company and its business at a particular point in time, usually at both signing and completion. The maker of the warranties – the company but also often the founders personally – may be liable for damages for failing to adequately disclose any fact that would make a warranty untrue at the time it was given. Founders are therefore encouraged to spend sufficient time with management preparing the disclosure letter; it is the best protection against warranty claims.

A common mistake when drafting transaction documents is to use a warranty to address a specific risk discovered during due diligence. However, warranties are unlikely to protect an investor from such known risks. Under English law – the law most commonly used in cross-border VC deals – prior knowledge of the facts or circumstances leading to a breach may serve as a bar to making a warranty claim. In these circumstances, a condition precedent, post-completion covenant and/or indemnity (discussed below) should be used instead.

Compensation for breach of warranty is not guaranteed – the onus is on the investor to prove breach and loss. Loss is quantified not by the cost to remedy but instead by the decrease in the value of the investor's shares caused by the breach—which may be difficult to prove. Moreover, recovery is subject to any financial limits, time constraints, baskets (that is, the minimum amount before claim can be made) and materiality/knowledge qualifiers that the investment agreement may contain. Investors should therefore carefully evaluate the aggregate effect of these limitations during negotiations.

Known risks which can be eliminated

Translation: Conditions precedent/post-completion covenants

If the risk is known and capable of being eliminated by the company, a condition precedent or post-completion covenant should be used. If the risk is material, the investor should request that the company eliminate it before completion – if the condition precedent is not satisfied, the investor is not obliged to make the investment. If the risk is not material, the parties may agree that it will be addressed within a specified period of time after completion. Tip for investors: depending on the nature of the risk, consider requiring an indemnity for losses suffered before the fulfilment of the post-completion covenant.

Known risks which cannot be eliminated

Translation: Indemnities

Investors should use indemnities to protect against specific risks that cannot be eliminated before completion (e.g., a potential tax liability or unresolved litigation). Unlike a warranty, an indemnity is a guaranteed remedy. It is a promise to reimburse the investor on a dollar-for-dollar basis for a particular type of liability, should it arise. The investor need only show that the loss has occurred and what it costs to remedy. There is no need to prove any diminution in the value of the company, only the cost to fix the problem.

Valuation and performance risks
Translation: Tranches, ratchets and anti-dilution protection

When investors and founders cannot agree on valuation and structuring the deal as a convertible loan is not on the table, one solution is to stage the investment, with each completion subject to achieving certain targets. Where investment tranches are not desirable, ratchets may be used to reallocate shareholdings if certain milestones are not met. A ratchet is an option exercisable on the occurrence or non-occurrence of certain events. If an agreed milestone is not reached (that is, an earnings or EBITDA threshold is not met), a pre-determined number of shares are issued or transferred as compensation for the resulting reduction in the value of the investment. Ratchets can also be used to guarantee a minimum internal rate of return (IRR) through the issuance or transfer of additional shares to the investor immediately before a liquidity event.

Another customary provision used to mitigate valuation and performance risks is anti-dilution protection. This provision requires the company to issue additional shares to the investor in the event of a subsequent round at a lower valuation (a "down round"). It comes in two flavors: "weighted average" and "full ratchet." Investors rarely get push back when asking for broad-based weighted average anti-dilution protection as this formulation takes into account not only the lower price but the number of new shares issued in the down round, which in most cases results in a reasonable level of dilution to the existing shareholders. In contrast, full ratchet protection is an aggressive ask as it means that the conversion price of all of the investor's shares is automatically reduced to the price paid in the down round. As a result, the investor effectively gets a price adjustment to the price paid in the down round at the expense of the existing shareholders.

Relationship risks
Translation: Veto rights and deadlock resolution

Investors often seek to minimize the risk of dissent over the strategic direction of the business by agreeing in advance on a business plan and budget, which is reviewed annually. They also negotiate veto rights over other major decisions. Veto rights provide a minority investor with negative control over critical issues affecting the business. A properly advised investor will ensure that these governance rights apply to each group company and not just the holding company in which the investment is made.

With veto rights come the risk of deadlock over a material issue. A put option or redemption right is the preferred remedy for the investor, but such provisions are often difficult to negotiate and are dependent on the financial resources of the counterparty at the time of exercise. A more generally acceptable solution is the engagement of an investment bank to conduct a sale of the company and, failing such sale within a reasonable period of time, a buy-sell provision (so-called Russian roulette) or binding arbitration.

Exit risks

Translation: Liquidation preference, tag-along and drag-along rights

A liquidation preference is a common investor downside protection. It is typically expressed as a multiple of capital invested, usually 1x. In the event of a sale of the company, the investor would be entitled to receive back US$1.00 for every US$1.00 invested, in preference over the holders of ordinary shares. Investors with significant leverage in the negotiation process sometimes insist on a higher liquidation preference multiple and/or ask for "participating" preferred shares. This means that on a sale of the business, the preferred would first receive back its liquidation preference and then the remaining proceeds would be shared by the ordinary and preferred according to their relative percentage share ownership.

Investors also typically require a tag-along right – a standard provision which provides that, in connection with a sale of control, the acquirer must purchase not less than all of the investor's shares at the same price and on the same terms and conditions. Moreover, investors frequently negotiate a drag-along right, which entitles them, together with the holder of a majority of the shares, to force a sale of the company. Less common but also useful is the right to appoint an investment bank to market and sell the company if an exit is not achieved within a reasonable period of time (e.g., five years). Having such rights substantially reduces the investor's risk of being trapped in an illiquid investment.

Summary

This article is intended to provide the most common family office investor protections found in cross-border growth and venture capital deals, along with the business risks they address. All of these transactions require expertise in multiple disciplines and jurisdictions. Please contact us if you or your family office need support on these complex transactions.

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