

10 THINGS TO KNOW ABOUT VENTURE DEBT



After the venture debt shake up in March 2023, there was an expectation that venture debt funding would dry up. However, as new players have entered the scene and equity markets remain tight, venture debt financing continues to be a popular source of funding for companies unable or willing to access the equity markets. Rather than pursue what may be a down-round equity financing and often at the encouragement of their venture investors, early stage companies are continuing to line up venture debt facilities for additional working capital and to shore up their balance sheets. Before taking on a venture debt credit facility here are 10 things a borrower should know.

NON-DILUTIVE (MOSTLY)

A major advantage of debt over additional equity is that debt is non-dilutive to the capitalization of the company. However, most venture lenders require an equity kicker, in the form of a right to co-invest in the next preferred equity round, or, more often, the issuance of a warrant (a right to purchase equity interests). The warrant is typically for common stock or the most recent preferred equity round, priced either as a penny warrant or at the price of the most recent 409A valuation/price of the last preferred equity financing, if available. The number of warrant shares is typically based on a certain resulting ownership percentage or calculated based on a percentage of the principal amount of the loan. The type and terms of any equity kicker will be negotiated at the term sheet stage.

STAGE OF COMPANY

Most institutional venture lenders will expect at least one preferred round of equity financing before being willing to provide a venture debt facility. Private

credit funds may be more willing to come in at an earlier stage, but borrowers should expect a higher cost of interest or greater equity requirements to balance out the risk.

FORM OF LOAN

Funding may occur in the form of a single term loan distributed in full at closing. It may also be a delayed draw term loan, with additional amounts becoming available as the company achieves certain pre-agreed milestones following closing. The size of the debt facility may also be determined by the calculation of a “borrowing base”, where the aggregate principal amount outstanding cannot exceed an agreed percentage of the value of the company’s eligible receivables, inventory, or recurring revenue.

COLLATERAL

Venture lenders typically receive a first-priority (senior) security interest in all assets of the company. It is common for intellectual property to be excluded from the collateral grant, but remain subject to a negative pledge (prohibiting the pledge of the IP to anyone else). Excluding the IP from the security package allows a company to provide outbound licenses of its IP to third parties without the approval of a lender.

APPROVALS REQUIRED

Various consents and approvals will need to be obtained in connection with any venture debt financing. Consent of the board of directors will be required and often shareholder consent is also needed in connection with the warrant issuance and/or the incurrence of debt over a certain amount. Additionally, venture lenders typically require that all existing debt of the company, including convertible notes, is subordinated to the new debt facility, and the maturity date of all debt is later than the maturity date of the new debt. Any existing noteholders (including convertible noteholders, founder noteholders and/or friends and family noteholders) will be expected to sign subordination agreements and possibly amend the terms of the existing notes.

THIRD-PARTY ITEMS

In addition to the consents mentioned above, a secured lender will typically require a company to seek certain deliverables from other third parties. Some institutional venture lenders will require a company to move the majority of its depository accounts to the lender bank. Notwithstanding this requirement it has become standard to allow borrowers to keep some percentage of funds outside the lender bank (typically at least two payroll cycles). For any accounts maintained outside of the lender’s institution, or for non-bank lenders, the venture

lender will require that company put in place a tri-party agreement among the company's depository bank, the lender and the company, providing the lender the right to take control of the deposit accounts following the occurrence and continuance of an event of default under the loan agreement. Venture lenders will typically also require that the company use commercially reasonable efforts to obtain an agreement from its current landlord(s) at any leased location where books and records or valuable property is located, providing the lender the right to access the leased space and remove the company's property following the occurrence and continuance of an event of default under the loan agreement. Additionally, lenders will often require that endorsements are added to the company's general liability and property insurance policies naming the lender as an additional insured and lender loss payee, as applicable, on the policies.

RESTRICTIVE COVENANTS AND REPORTING OBLIGATIONS

Venture debt agreements contain tight restrictions on a company's ability to engage in certain activities without lender consent, such as the incurrence of additional debt and liens, making investments, acquisitions and distributions to shareholders, and material changes to the borrower's capital structure (including a change in control). Loan agreements also contain periodic reporting obligations, including the delivery of annual audited financial statements and either quarterly or monthly company-prepared financial statements.

COMPLIANCE WITH THE BUSINESS PLAN

Lenders may use financial covenants to track a company's performance in line with the business plan shared with the lender during its due diligence process. Financial covenants for emerging companies are typically limited to achieving a certain EBITDA growth (often as a declining negative number), or maintaining minimum liquidity. However, it is not uncommon for a venture debt agreement to not have financial covenants given the early stage of the company. Instead of financial covenants a venture lender may look to include an event of default that is either triggered by a material adverse change (MAC) with respect to the business or a lack of investor support. A MAC event of default is intended to serve the same purpose as a financial covenant, allowing a lender to cut off additional funding, exercise remedies and/or re-negotiate the loan agreement if the company is not performing as expected. An investor support event of default is triggered when the lender determines that there is clear intention of the borrower's investors to no longer fund the company in amounts necessary to repay its debt obligations. Unlike a financial covenant, there is more room for a lender's discretion in determining if a breach has occurred under a MAC or investor support event of default.

DEBT SERVICE AND FEES

Companies with venture debt facilities must have cash flow or another cash source in order to pay principal, interest, fees and expenses associated with the loan. When the term sheet is signed, the lender typically requires a deposit that is non-refundable but is applied against its diligence and documentation expenses. At closing, a borrower will typically pay an upfront fee to the lender, as well as all reasonable expenses of the lender, including its attorneys' fees. The initial term of the facility following closing (anywhere from the first year to 18 months) is typically an interest-only period, during which only interest payments will be required and there is no required pay down of principal. Thereafter, the borrower will need to make regular installment payments of outstanding principal in addition to interest. There may also be annual monitoring or administrative fees and a final "exit" fee at payoff. If the company wishes to terminate the facility early, there is often a prepayment premium (that may decline over time). The repayment terms, amortization schedules, and various fees are all negotiated as part of the term sheet for the facility.

PERSONAL GUARANTY

For an early stage, pre-revenue company, the venture lender may request a personal guaranty from the founders depending on the lender's assessment of credit risk. Not all personal guarantees are created equal. The most punitive is a full backstop of the company's obligations to the lender, with the lender being able to seek repayment from the founders personally without exhausting remedies against the company. A more limited version of this would be a capped dollar amount and a requirement that the lender first seek repayment from the company. The most limited form of personal guarantee is what is often called a "bad acts" guaranty; limited to indemnification by the founders in the event of certain specified actions of a founder, such as fraud or misappropriation of funds. Before agreeing to a personal guaranty in a term sheet, it is important to have a clear understanding of what type of personal guaranty a venture lender is requesting and whether such a guaranty is appropriate for the type of loan being offered.

This summary is only a snapshot of the components of venture debt lending. If you have any questions or if you are interested in exploring the venture debt market further, please contact Jennifer Audeh, Anne Seymour or another member of the [Foley Hoag Debt Finance Group](#).

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