Venture Debt for Life Sciences Borrowers

This article provides a brief introduction to the venture debt industry, particularly from the perspective of life sciences businesses that might be contemplating venture debt finance. We highlight some of the key legal issues and considerations that commonly arise for borrowers in these types of transactions, and provide some high-level tips and negotiation considerations.

What is Venture Debt?

Venture debt is a catch-all term for lending to early stage companies that, due to the nature of their business model, do not yet have a meaningful (or sometimes any) revenue stream, but who have the potential for rapid growth in the short to medium term. Lenders in this sector will generally base their lending criteria on the availability of further equity finance to the company from existing or new investors, the experience and track record of its management team, the scope and potential value of its intellectual property and any applicable regulatory approvals, tests results and milestones.

Venture debt might often, but not always, involve some potential equity element, either in the form of convertible debt or, more commonly, a warrant 'kicker', but can just as easily take the form of straight debt-financing. Given the inherently high-risk nature of venture debt from a lender's perspective, such financing transactions are frequently secured to some degree.

Unlike more traditional forms of debt finance, venture debt will usually arise somewhat earlier in a company's lifecycle and will often bridge the gap in the timeline between the initial equity financing rounds and a more mainstream banking facility as the company grows. Venture debt is particularly common in the life sciences industry where businesses have a long runway to reach financial profitability and often significant research and development costs along the way. Thankfully for many businesses, there are an increasing range of specialist lenders operating in this sector and the market is growing all the time.

Following BREXIT and the UK government's commitment to the life sciences industry following its leading COVID-19 vaccination roll-out, now is an optimal time for life sciences businesses to grow within the UK market and venture debt financing will provide one of the key pathways to facilitate that growth.

Venture Debt for Life Sciences Borrowers

The Benefits of Debt

The key benefits of using venture debt as opposed to equity financing are as follows:

1. The obvious benefit is that it does not lead to dilution of the existing shareholders of the business. Careful use of debt financing may negate the need for a series C or D round of equity financing or at least provide a longer runway for research and development or general growth of the business before further equity financing is called upon.

2. Debt financing can be faster and cheaper than a full equity round.

3. Having access to a debt facility (even if it is not fully drawn) can provide a useful cash contingency in the face of unexpected future costs and mean that the company has more breathing space while it negotiates further commercial deals.

4. Debt financing will rarely require the provision of a board seat, as might more often be the case with venture capital equity investors, and so the existing board of the company retains more control over the business.

The above advantages must of course be weighed against the usual risks of debt in that it will require a cash management strategy for its eventual repayment and it runs the risk for equity holders that the debt will rank ahead of them in the event of insolvency. However, these inherent features of debt do not frequently negate its appeal or utility.

Sources of Debt Finance - Bespoke Options

There are many sources of venture debt financing and the pool of lenders is expanding regularly. Some lenders are established banks, but most are specialised lending institutions or funds. There are many U.S. headquartered lenders that operate in this area as the U.S. has traditionally been a larger and more developed market for these services, although there are an increasing number of these firms operating in the UK and EU markets and a number of domestic players as well.

The obvious advice for any borrower that is contemplating venture debt finance is to shop around and get a number of term sheets from different institutions. As the market is evolving there is no standardised form of deal in this area and lenders will tailor a potential loan to a given borrower.

Borrowers should look carefully not just at headline interest rates, but also at the myriad of related costs, expense payments, and whether lenders will offer interest free periods (many will for between 3 to 18 months), as well as whether or not warrant coverage and/or financial covenants are required. Whether a loan is secured or not (and if so, the extent of the security) can also have a significant impact on both the overall cost and speed of the financing and the ease of operation of the business over the life of the loan. A shrewd borrower that is not up against a hard funding deadline can often tailor a finance offering in a manner that best suits its asset and shareholder structure, which is why it sometimes pays to explore funding options well in advance of the end of the existing cash runway.

Tips for New Life Sciences Borrowers

The following are some key considerations for life sciences businesses to consider when embarking on potential venture debt financing, although many of these points will be relevant to any borrower and this list is certainly not exhaustive of the numerous issues to be negotiated in a typical financing transaction.

Timing, Structure, and Planning

- Allow a reasonable amount of time to complete the transaction. Many lenders say that a deal can be done in 4-8 weeks from the term sheet stage. This is certainly achievable, although be aware that the lower end of this spectrum (or any even shorter timeframe) is usually only achievable if the borrower capitulates and agrees to most of the lender’s standard terms -- this is seldom in the interest of the borrower in the long term. Bear in mind that, unlike equity, the covenants and representations of the debt finance last the life of the loan (which is often up to 5 years) and it is usually worth spending the time where possible to negotiate the exemptions you are likely to need for your business upfront wherever possible rather than to seek waivers after the deal is signed.

- Plan your bandwidth internally as much as possible in advance. If your team is not experienced with finance documents, note that they can be long, complex and touch on multiple aspects of the business - they may require input from your technical/scientific teams as well as your finance and operations teams and if your management team is small, running a debt finance transaction in conjunction with other major transactions can cause bottlenecks.

- Where possible, limit the security scope at the outset with your lender. If the transaction is going to have security (see more on this below), be aware that the legal documentation (and the associated time and scope for issue complexity) can increase significantly with each new jurisdiction and each company in the borrower group; this does not necessarily correlate with the value of the transaction itself -- it is far more straightforward to complete a £50m deal in one jurisdiction with one borrower than it is to complete a £5m deal with multiple borrowers and secured parties with assets across half a dozen jurisdictions.

Tips for New Life Sciences Borrowers

Timing, Structure, and Planning (Continued)

- Once you have the key commercial terms in a term sheet, involve your legal counsel before executing the term sheet. While it is understandable that businesses may prefer to involve lawyers as late as possible in the transaction due to perceived cost savings, the review time on a term sheet is fairly minimal and it often pays to flag potential key legal points up front. It is generally better to identify these at the term sheet stage so that (i) if a deal-breaker is identified early on it can result in a new lender being approached without incurring further costs on this transaction; and (ii) if it is something that is bespoke and requires more senior review/analysis within the lender's organisation, this matter can be run up the chain of command in a timely manner - the more time there is to resolve an unusual issue, the more likely there will be a favourable result for the borrower; last minute issues almost inevitably result in the borrower needing to make a compromise on its preferred position.

- Getting key commercial points (and exceptions/carve-outs from typical restrictions) agreed at the term sheet stage also saves considerable time and expense negotiating them for the first time in the substantive documentation.

The Commercial Terms and Conditions to Drawdown

- The majority of the commercial terms with any venture debt loan will of course be dictated by the financial needs and status of the business rather than legal issues. However, borrowers should certainly be aware of the advantages of taking a loan in tranches so as to not be paying interest on the whole amount up front.

- Conversely, if a loan is tranched, borrowers should always ensure that any additional conditions precedent to drawing the second or subsequent tranches are very clearly defined and achievable. Particularly in the life sciences industry where drawing subsequent tranches is often tied to reaching certain milestones or the success of one of more clinical trials, borrowers should always make sure that their technical teams work closely with their lawyers and their lender to ensure that what constitutes "success" for the purposes of a given clinical trial or other milestone is clear and unambiguous. Where possible seek to plan for less common eventualities so that the loan can still be drawn if needed (for example, perhaps on slightly less favourable terms if the trial results are negative or not quite as strong as expected). Borrowers should always seek to avoid a scenario where there is either ambiguity as to whether a condition is fulfilled or they find themselves unable to draw a loan they had been intending to rely on when faced with an unwelcome clinical result (which will often occur just at the time when more cash may well be needed and might not be forthcoming from other sources).

- Borrowers will often want to ask for an "interest only" period for their loan and most lenders will be accommodating to this request -- interest only periods may last 3-18 months depending on the circumstances and can sometimes be extended through subsequent negotiation.

The Commercial Terms and Conditions to Drawdown (Continued)

- Borrowers should also seek to build in the ability to prepay the loan upon notice. This will usually come at a cost to reflect the lender's loss of potential interest over the life of the loan, but this cost can usually be negotiated downwards to some degree and the additional flexibility of being able to refinance the loan easily if needed is usually worthwhile.

Covenants

- Financial covenants may sometimes be requested by some lenders (certainly these are more common in conventional loans). Given that many venture companies are not yet trading or at least have limited trading histories, specific financial covenant ratios can often be resisted and this is something to be welcomed or pushed for by most borrowers. Lenders can usually gain comfort by having covenant caps on, e.g. the amount of further debt that can be taken on without consent, or approval rights in relation to material expenditure outside of the business plan in a given year.

- Borrowers should be aware that, even if the transaction documentation does not include specific financial covenants, it will no doubt include a potentially large number of restrictive and prescriptive covenants that apply for the life of the loan. These are always amongst the most heavily negotiated aspects of the transaction documentation and won't always be flagged up front in the term sheet.

- One of the key covenants that often goes to the heart of the commercial operation of a business is whether there is a restriction on being able to dispose of or license out assets without prior lender consent. In a life sciences business, the core revenue generating function of the business is likely to be either the sale or licensing of its intellectual property ("IP"). This ties in to the scope of the security package as well (see below) but while lenders certainly have a legitimate need to safeguard the assets of the business and ensure that they are not disposed of undervalue, borrowers will understandably be concerned about needing to have prior lender approval for any commercial deals they might want to make - this can not only impact their freedom to operate but also their ability to close commercial transactions quickly (not to mention that waiver and administration fees may be charged by some lenders).

- Borrowers should consider negotiating mechanisms to either (i) exclude IP altogether from restrictive sale and licensing covenants and security packages (the ideal position from a borrower's perspective); (ii) allow the borrower freedom to sell or license assets provided the company is not in default under the loan, (iii) allow the borrower freedom to sell or license assets provided this is on arm's-length terms in the ordinary course of business, (iv) allow the borrower freedom to sell or license assets provided the proceeds of such sale or licence are secured for the lender's benefit (only in a secured deal) or paid into a designated account held with a lender (if the lender is also a bank); (v) allow the borrower freedom to sell or license assets up to a fixed value each year without prior consent; or (vi) implement some combination of the foregoing. These examples are by no means a conclusive list of options but reflect a variety of the compromises sometimes agreed in these circumstances.

Tips for New Life Sciences Borrowers

The Equity or Uplift Element

- Not all transactions in the venture debt space will involve warrants but many will include them so that the lender gets some of the upside following any growth in the business. When negotiating warrants, borrowers should be conscious of any adjustment mechanisms in relation to the same and seek to limit or even exclude these as much as possible -- the warrants in the context of a venture debt deal are designed to give the lender a limited “kicker” or bonus, they are not intended to guarantee a fixed proportion of ownership of the company in the long-term. Ideally from the borrower’s perspective, a set number of warrants will be issued with a narrow and clearly defined pricing formula. Borrowers should be aware of the fact that complex or protracted adjustments and/or calculations made by third parties can sometimes have significant future administrative costs and complexities.

- An alternative that is sometimes more straightforward than issuing warrants is to agree a capped cash uplift payment based on the completion of certain milestones and calculated by reference to the share price of the borrower at a specified time.

Security

- Broad ranging security packages are relatively common in venture debt transactions. That said, it is often possible for borrowers to negotiate exclusions and exceptions from the security package. If a borrower has any upcoming licensing or IP sale transactions, it will generally be prudent to exclude the IP for such transaction from the lender security documents.

- Life sciences borrowers may also wish to try to exclude IP more generally from their security so as to give them flexibility to license the same free from encumbrances in future. Some lenders will agree this provided that they retain security over bank accounts and any cash receivables due in respect of such licensing or sales. This can often make negotiation of third party commercial contracts and licences more straightforward as there is no need to obtain prior lender consent or deal with security releases.

- If a lender insists on security coverage over IP, borrowers should consider contractual mechanisms to allow for deemed approvals from lenders in certain circumstances (e.g. depending on transaction value and the absence of a borrower default etc.) or to mandate certain response times and deemed consent so as to not delay potentially time sensitive licensing or IP disposal transactions.

Security (Continued)

- One legal technicality to consider that can sometimes have far-reaching timing and cost implications, particularly for a life sciences or technology business that has IP registered around the world, is the scope of registration of any IP transaction security. While in some cases security may be granted broadly across IP in many jurisdictions, the separate process of then registering that security in favour of the lender across multiple markets can be both costly and time consuming (and may often be of negligible benefit to the lender as well if the security is already registered in the borrower’s home jurisdiction and in limited key markets). While it is relatively easy to register security interests in the UK or the U.S.A., some jurisdictions have prohibitive pre-requisites to security registration or costing systems that make the process uneconomical. Borrowers would be well advised to discuss security registration of any secured IP with the lender at the early stages of any secured transaction and seek to limit any registration to only those key markets where the process is prompt and economical.

- In most secured lending transactions, it is fairly common for lenders to take security over insurance policies and the proceeds of the same. In a life sciences business, note that some insurance policies won’t be for the benefit of the business itself but for third parties (e.g. cover to protect participants in clinical trials). It is recommended for such policies to be excluded from any security package and this is usually not controversial given that lenders will struggle to benefit from security in respect of such policies in any case.

Third Party Approvals

- Many businesses that take on venture debt will already have existing debt, often from founders or other shareholders who may have provided loans to the business or taken loan notes from the company. In order to make a transaction flow smoothly and to minimise potential delays, it is useful if prospective borrowers have a good understanding of their existing debt obligations and terms as it is likely that an incoming venture debt lender will require other creditors to subordinate their loans to the venture debt. If a borrower suspects an existing creditor might not be willing to do this (or simply won’t respond promptly enough), it is worth discussing exemptions with the new lender at the outset. Very often existing lenders have limited incentives to grant consents or, if they do, to act quickly.

- Make sure that all corporate and regulatory filings are up to date. All loan agreements will likely require representations in relation to the status and accuracy of the same and, if this is not the case, it can cause delays to closing while records are updated.

- If the transaction involves an issuance of warrants or other equity or convertible instrument, check in advance whether sufficient authority to allot already exists or if further shareholder approvals are needed (either as a matter of corporate law or pursuant to any applicable shareholder agreements or other third party contracts). If further approvals are needed, these need to be factored into the timetable.

Third Party Approvals (Continued)

- Given that they are IP focussed, most life sciences companies will have fairly robust employment contracts with their scientific staff in relation to the ownership by the company of any IP. However, in the event that this is not the case or any IP is jointly owned with third parties, consider in advance what consents might be required if the transaction in question is going to need to grant security in respect of IP holdings. Waiting to negotiate such points until near the end of the transaction process can cause delays and it is usually preferable to run any such discussions in parallel with the negotiation of the primary debt documents.

If you have any questions concerning the material discussed in this article, please contact the following members of our Venture Debt practice

---

Alexander Clarke
Of Counsel, London
+44 20 7067 2380
aclarke@cov.com

Denitsa Marinova
Associate, London
+44 20 7067 2235
dmarinova@cov.com

Ross Finnie
Associate, London
+44 20 7067 2093
rfinnie@cov.com

COVINGTON