Term Sheet Negotiation: Legal Aspects

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Overview of a Term Sheet

- Concept, form, structure and content

What it is

A short summary of the venture capital transaction’s main terms

What it looks like

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TERM SHEET
FOR SERIES A PREFERRED STOCK FINANCING OF
[*INSERT COMPANY NAME*], INC.

[__, 20__]

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [___________], Inc., a [Delaware] corporation (the "**Company**"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality [and Counsel and Expenses] provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors. This Term Sheet shall be governed in all respects by the laws of [______________the].

Offering Terms	
Closing Date:	As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the "**Closing**"). [*provide for multiple closings if applicable*]
Investors:	Investor No. 1: [_______] shares ([__]%), $[_________] Investor No. 2: [_______] shares ([__]%), $[_________] [as well other investors mutually agreed upon by Investors and the Company]
Amount Raised:	$[_______], [including $[_______] from the conversion of principal [and interest] on bridge notes].
Price Per Share:	$[_________] per share (based on the capitalization of the Company set forth below) (the "**Original Purchase Price**").
Pre-Money Valuation:	The Original Purchase Price is based upon a fully-diluted pre-money valuation of $[_____] and a fullydiluted post-money valuation of $[______] (including an employee pool representing [__]% of the fullydiluted post-money capitalization).
Capitalization:	The Company's capital structure before and after the Closing is set forth on Exhibit A.

CHARTER	
Dividends:	[*Alternative 1:* Dividends will be paid on the Series A Preferred on an asconverted basis when, as, and if paid on the Common Stock] [*Alternative 2:* The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.] [*Alternative 3*: Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[_____] per share of Series A Preferred when and if declared by the Board.]
Liquidation Preference:	In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows: [*Alternative 1 (non-participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock.] [*Alternative 2 (full participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis.] [*Alternative 3 (cap on Preferred Stock participation rights)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).] A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "**Deemed Liquidation Event**"), thereby triggering payment of the liquidation preferences described above [unless the holders of [___]% of the Series A Preferred elect otherwise]. [The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to escrow in connection with a Deemed Liquidation Event.]
Voting Rights:	The Series A Preferred shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) **[so long as [*insert fixed number, or %, or "any"*] shares of Series A Preferred are outstanding,]** the Series A Preferred as a class shall be entitled to elect [_______] [(_)] members of the Board (the "Series A Directors"), **and** (ii) as required by law. The Company's Certificate of Incorporation will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock.
Protective Provisions:	[So long as [*insert fixed number, or %, or "any"*] shares of Series A Preferred are outstanding,] **in addition to any other vote or approval required under the Company's Charter or Bylaws,** the Company will not, without the written consent of the holders of at least [__]% of the Company's Series A Preferred, either directly or by amendment, merger, consolidation, or otherwise:

Its structure and content

Names of parties – Company

- Investor
- Founders
- Type/name of company (usually JSC)

Economic Terms

- Amount raised
- Price per share
- Pre-money valuation
- Capitalization (cap table)
- Dividends distribution
- Anti-dilution
- Liquidation preference

Governance

- Chairman – General Manager
- Board of Directors (number of seats – representation – powers)
- Applicable quorum and majorities in the company’s bodies
- Non-competition undertaking by founders
- Reserved matters or Matters requiring consent

Shareholding

- Preferred v. common shares
- Founders lock-up
- Preemption rights
- Preferential right to subscribe to a capital increase

Exit – facilitating investor's exit

- Redemption rights
- Tag-along
- Drag-along

Miscellaneous

- Exclusivity
- Confidentiality
- Counsel and Expenses

The Term Sheet: a negotiation document

- Binding or non-binding?

- The negotiation of a VC deal takes weeks or months
- It starts with a Term Sheet that crystallizes the agreement of the parties on the main points
- The Term Sheet is a negotiation document
- Importance of the negotiation of a Term Sheet:
  - Shortens and facilitates the negotiations
  - But be aware: You cannot go back! (lowers the negotiation leverage)

- **Not-binding as a matter of principle**

→ No commitment on either parties to proceed with the transaction

→ The Term Sheet merely sets the negotiation framework

→ Either they realize that they are unable to agree on main terms → they end the negotiation

→ Or they reach an agreement and sign the final documents (SHA, SSA)

- **<u>However, it may contain binding provisions</u>**
- Examples:
  - Undertaking to negotiate in good faith
  - Undertaking of confidentiality (existence of the negotiations – information gathered during the due diligence)
  - Undertaking of exclusivity (negotiate exclusively with each other during a certain period of time – but make sure it is limited in time!)

Some basics on VC deals

- DOs and DON'Ts

Figures and what they mean

- Pre–money = valuation of the company prior to the investment
- Post–money = pre–money + investment
- % of shares that the investor will get = investment / post–money
- Number of shares to be issued to the investor – formula (based on the % of shares and the initial number of shares in the company)
- Issue price = investment / number of shares

What is a cap table

		Pre-Investment		Post-Investment	
	Type of shares	Nb. of shares	Percentage	Nb. of shares	Percentage
Founder 1	Common	325,000	48.15%	325,000	43.33%
Founder 2	Common	125,000	18.52%	125,000	16.67%
Employees (Employees Stock Options Plan)	Common (Issued)	0	0%	0	0%
	Common (Unissued)	225,000	33.33%	225,000	30%
Investor	Priority	0	0%	75,000	10%
Total		675,000	100%	750,000	100%

Liquidation preference

- Applies in case of a "Liquidation Event"
  - Liquidation, dissolution, winding up
  - Consolidation, merger, acquisition, sale, transfer, disposition of assets

It is all about how/in which order of priority to distribute the liquidation proceeds among the shareholders

Liquidation preference: 3 types

1. **Non-participating**: proceeds to be distributed to the preferred shareholders. Thereafter, the balance pro-rata to common shareholders.
2. **Fully-participating**: proceeds to be distributed to the preferred shareholders. Thereafter, the balance pro-rata to both preferred and common shareholders.
3. **Partially-participating**: proceeds to be distributed to the preferred shareholders. Thereafter, the balance pro-rata to both preferred and common shareholders.

   However, preferred shareholders stop "participating" when they receive a certain amount.

Liquidation preference: Do’s and Don’ts

- Negotiate a Non-participating or at least a Partially participating
- Try to reject multiples of Investment (eg. 2x Investment)

- Avoid Fully participating

Do’s

Don’ts

Anti-dilution

- Applies in case of a down round (dilution resulting from issuance of stock at a lower price than the price paid by investor)

- Adjustment mechanism in favor of the investor that is diluted

Anti-dilution: 2 types

1. **Full ratchet**: Investor requires that the new price (paid by new investor) applies to him retroactively
2. **Weighted average**: Investor will require that an average issue price applies to him

Anti-dilution: Do's and Don'ts

Do's

- Weighted average
- Negotiate a minimum adjusted price (the adjusted price cannot in any case be lower than a certain number).
- Limit the exercise of anti-dilution in time: ex: maximum 18 months.

Don'ts

- Avoid Full ratchet

Drag-Along / Tag-Along

- **Drag- Along**: Right of a shareholder, upon receiving an offer to sell the company, to “DRAG” the other shareholders into the sale = to force them to sell their shares also.
- **Tag- Along**: Right of a shareholder, upon other shareholders selling their shares in the company, to be “TAGGED” to the sale = to join the sale and sell his own shares also.

Drag-Along: Do's and Don'ts

- High majority approval requirement to trigger the drag-along (2/3 of share capital)
- Push for a minimum sale price (eg. 2x the initial investment) to avoid that the founders receive nothing

- Exercisable by a minority investor
- Exercisable against the founders only

Do's

Don'ts

Reserved Matters or Matters requiring consent

- Matters that cannot be resolved by the company's bodies unless with the prior approval of:

  - A shareholder (ex: the investor)
  - A certain majority of shareholders, etc.

Reserved Matters: Do's and Don'ts

Do's

- Require a minimum threshold of outstanding preferred shares in order for the reserved matters to remain in place.
- Negotiate thresholds (eg. Indebtedness in excess of [.]).

Don'ts

- Do not give too much to avoid obstructing the normal course of business

Redemption Rights

- Right of the investor to force the company to repurchase the investor's shares
- Reason: limited life of a fund → after the expiry of the fund's life, the fund needs to be liquidated → if the fund cannot exit → Redemption Rights

Redemption Rights: Do's and Don'ts

- Strict conditions to exercise such rights (eg. only if the company's minimum gross margin is equal to a certain amount – cannot be triggered until 5 years from closing)
- Delayed payment terms: Redemption price to be paid in installments over a long period to keep sufficient cash for operations

- Redemption rights against the founders (only against the company)

Do's

Don'ts

Always remember to seek legal advice before it is too late…

A legally “solid” Term Sheet is a key to a successful VC deal

HAPPY FUNDRAISING ☺

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