Angel and Venture Capital Term Sheets

TCN
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INTRODUCTIONS

- Paul Sweeney - Corporate lawyer at Foley Hoag LLP
- Co-Chair of Technology Practice
- Named one of the “Top 20 Startup Lawyers in Boston,” and one of “Ten Most Innovative Lawyers in America” by the ABA Journal
- Have worked on over 100 angel and venture capital financings (debt and equity) over 14 years of practice.

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What is a term sheet?

- a/k/a- "Letter of Intent," "MOU," "Agreement in Principle"
- First major step in transaction, when material terms of deal are negotiated and agreed to
  - –Focus on the deal is at its maximum
  - –Gives road map for lawyers to draft actual docs
- How much detail? Beware of: "The definitive documents will contain customary provisions regarding liquidation preference, anti-dilution protection, board composition, and required consents."

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Non Binding (to a point....)

- A couple provisions are usually legally binding
  - Confidentiality (can't disclose terms)
  - Exclusivity (can't shop deal - usually 30-90 days)
- Ordinarily, term sheet is otherwise not legally binding
  - Either party can walk
  - Closing the deal is subject to negotiating actual docs, due diligence, closing conditions
  - But terms are "morally" binding – if you really want to mess up your transaction, the term sheet is the place to do it

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VC financing at its core

- A sophisticated investor (or group of investors) invests money (capital) into the company in return for newly-issued shares of the company, along with certain contractual rights.
- Shares acquired are usually convertible preferred stock
  - "Stock" – equity ownership (junior to debt)
  - "Common Stock" – basic unit of equity ownership; issued to founders/employees/consultants.
  - "Convertible" – converts into common stock
  - "Preferred" – has preference over common stock - dividends, distributions, liquidation, redemption, etc.

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Founders' Main Concerns

- Loss of control
- Dilution of personal equity position
- Stock gets "tied up", as well as subject to repurchase if terminated
- Is the financing adequate for your plans?
- Future capital needs and dilution?
- Success of partnership with angels and VCs – access to key industry contacts, future $, business guidance

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Investors' Main Concerns

- Accuracy of valuation (both present and projected)
- Risk level of investment, and ROI
- Liquidity if business in distress (downside protection)
- Ability to participate in later rounds (upside protection)
- Influence and control over management and strategic direction

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Overview

- Economics of the Deal
- Control of Company
- Monitoring and Preserving Investment
- Maintaining / Increasing Equity Position
- Liquidity for Investors
- Restricted Stock for Founders

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Key Terms

- Economics of the Deal
  - "Pre-Money Valuation"
  - Option Pool
  - Liquidation Preference
  - Anti-Dilution Protection
  - Dividends

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Pre-Money Terminology

- "I'll give you $2 million at a $3 million pre."
- "We want to buy two-fifths, with a total investment of $2 million."
- "The company is worth $3 million, and so I'm looking to own 40% when we're done."

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Pre-Money Valuation

- If my money is buying me shares, then exactly how many shares do I get and what percentage of the company do those shares represent immediately after my investment?

- Side note: Remember, the number of shares you hold only tells you half the story. Be careful of optics.
  – Compare Warren Buffet's 350,000 shares of Berkshire Hathaway (33.1% of 1,060,000 total shares) with 350,000 shares of Google Inc. (0.1% of 324,890,000 total shares)

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Pre-Money/Post-Money

- "Pre-Money Valuation" = imputed dollar value of the company before the new money is invested
- "Post-Money Valuation" = pre-money valuation + the amount invested.

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Pre-Money Valuation

- Allows us to calculate the share price and the % of company being sold.

$$\textit{Price} = \frac{\textit{Pre-Money Valuation}}{\textit{Pre-Money Shares Outstanding}}$$

$$\textit{\% Sold} = \frac{\textit{Shares Issued}}{\textit{Post-money Shares O/S}} = \frac{\textit{New \$}}{\textit{Pre-Money + New \$}}$$

- Pop Quiz: "I'll invest $5 million at a $10 million pre money."
- Question: What percentage would the investor own <u>after</u> the investment?

A: 33%

B: 50%

C: It's too soon after lunch for a math quiz

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Post-Money Valuation

Price = *Pre-Money Valuation* / *Pre-Money Shares Outstanding*

- "Option Pool" is critical issue
  - Options are rights to buy shares of common stock in the future at a set price. Granted to employees, consultants, advisors, board members.
  - The "pool" is the number of shares of common stock that you have reserved for options outstanding and options to be granted in the future.
  - Do we have a sufficient number of shares "reserved" to compensate and motivate existing and future employees?
  - The higher this number, the lower the share price for the investors, and thus the higher the number of shares issued for the same amount of money invested.
  - Bigger isn't always better.

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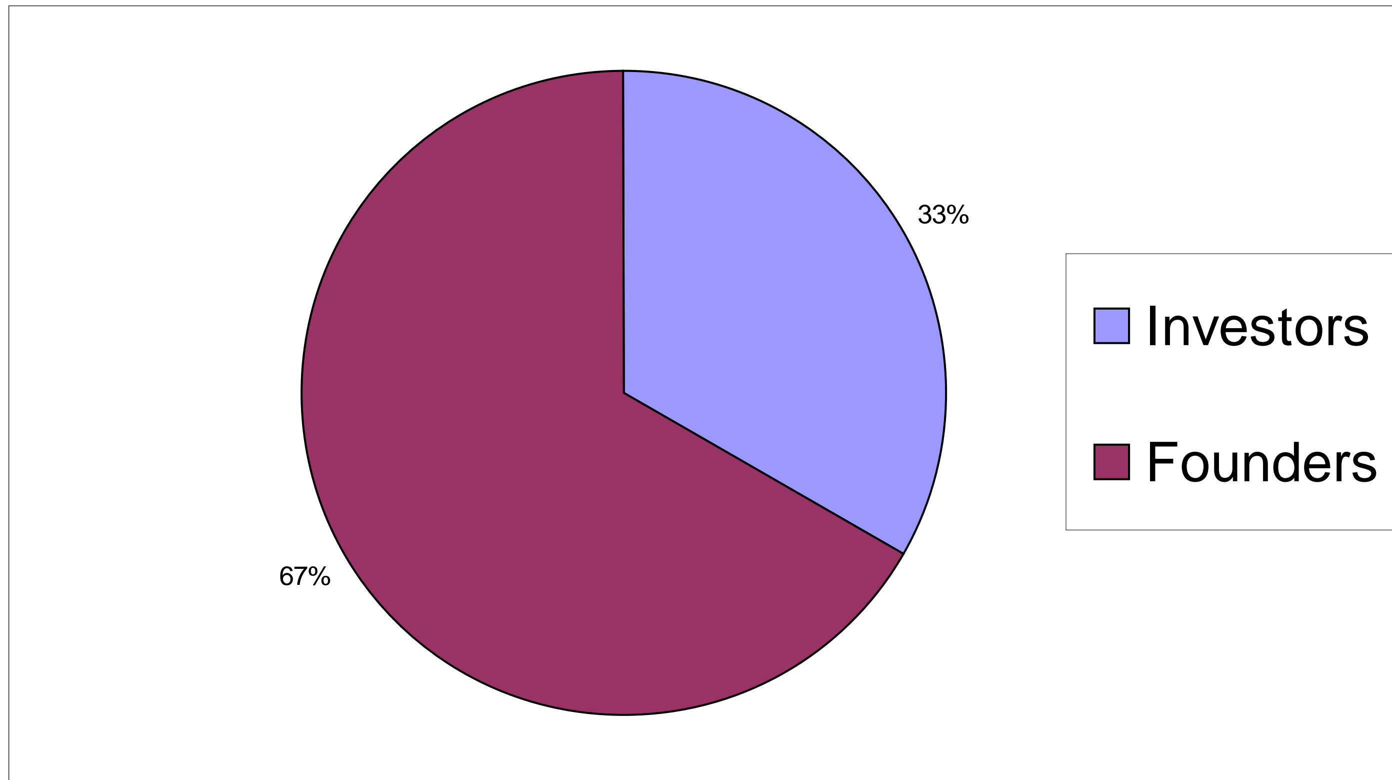
Option Pool

- Pre Money Valuation (Without Option Pool)



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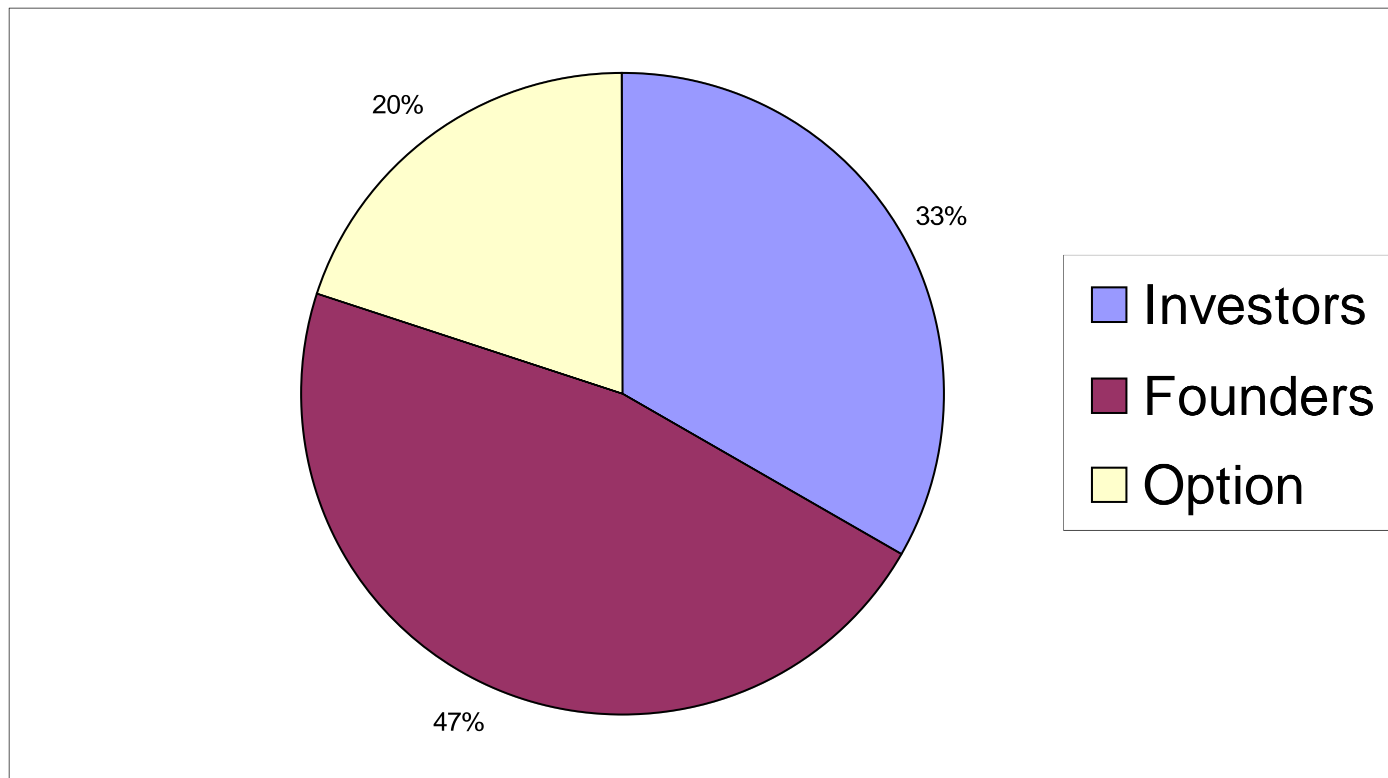
Option Pool

- Pre Money Valuation (With Option Pool)



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Easy Math Question

- Offer 1: Pre-Money Value of $10 million, $5 million investment, 10% Post-Money Option Pool

- Offer 2: Pre-Money Value of ***$11 million***, $5 million investment, ***20%*** Post-Money Option Pool

- Which is the "better" offer for the founders?

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Math Geek Part 1 Answer

- Offer 1, even though it's a lower "pre-money valuation." Founders' shares retain more value due to the smaller post-money option pool:

- Offer 1 Values:
  - Preferred Stock $ 5,000,000
  - Option Pool 1,500,000 (10%)
  - Common Stock ***8,500,000***
  - Total Post-money $15,000,000

- Offer 2 Values:
  - Preferred Stock $ 5,000,000
  - Option Pool 3,200,000 (20%)
  - Common Stock ***7,800,000***
  - Total Post-money $16,000,000

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Term Sheet Language

- Pre Money Valuation and Option Pool

“Pre Money Valuation: The Per Share Purchase Price will be $____, which is based upon a fully-diluted pre-money valuation of $____ million and a fully diluted post-money valuation of $____ million (including an employee pool representing ___% of the fully diluted post-money capitalization).”

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Related terminology

- "Up round" – where subsequent round is at a pre-money valuation that is higher than post-money valuation of the prior round
- "Flat round" and "down round"
- "Value" is sometimes the tail wagging the dog – in early stage companies, investors are often looking for a certain percentage of the company, and will back into a "valuation" that fits their math
- "Cap table" skills highly rewarded

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We got a high valuation!

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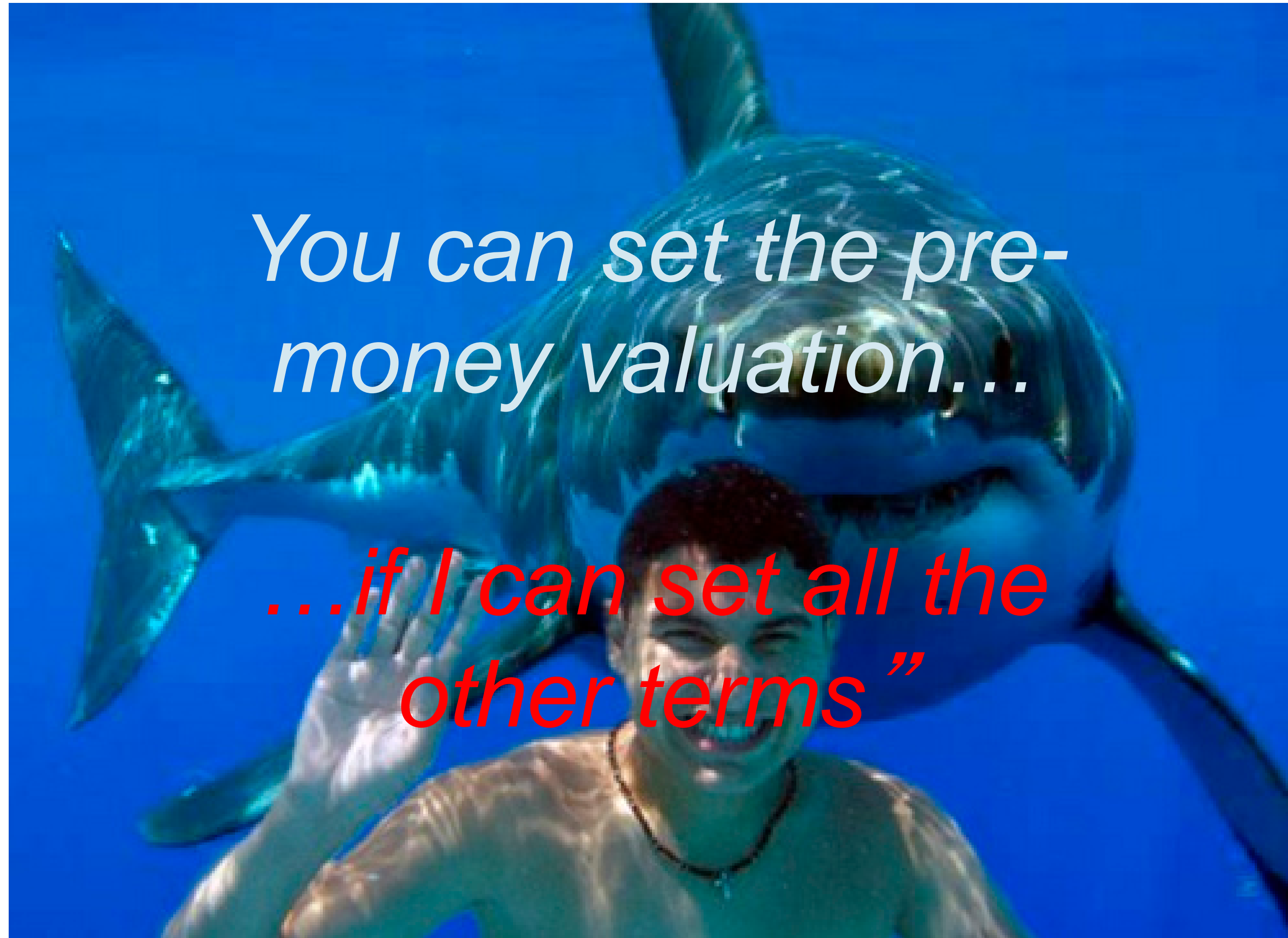
We got a high valuation!



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Liquidation Preference

- Applies when a "liquidation event" occurs (usually M&A)
- When distributing liquidation proceeds, preferred stock has right to get a certain amount of money back before the common stock gets anything (the "preference.")

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Liquidation Preference

- Sometimes "multiples" are used (1x, 2x, 3x the investment amount)
- Sometimes accruing dividends are added on.
- Sometimes the "preference overhang" (total amount of proceeds due to the preferred stock) is so great that the common stock is effectively worthless.

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Liquidation Preference

- Three main flavors (ranked in order of bitterness):
  - –Non-participating
  - –Participating preferred (with cap)
  - –Participating preferred (without cap)

Note: preferred always get the greater of either their preference or what they would receive if they converted to common stock

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What does the term sheet say?

"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 the Original Purchase Price on each share of Series A Preferred. *Thereafter, the balance of any proceeds shall be distributed pro rata to holders of Common Stock."*
- ***Alternative 2 (Participating Preferred Stock with Cap)*:** "First pay the Original Purchase Price on each share of Series A Preferred. *Thereafter, Series A Preferred participates with Common Stock on an as-converted basis until the holders of Series A Preferred receive an aggregate of [two] times the Original Purchase Price."*
- ***Alternative 3 (Participating Preferred Stock)*:** "First pay the Original Purchase Price on each share of Series A Preferred. *Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis."*

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Examples of Liquidation Preference

- Assume a $5m Series A investment at $20m pre-money valuation (resulting in the Series A investors owning 20% of the company). The company ends up being sold for $40m without any additional shares issued after the Series A investment.
- A "**1X Non-Participating Preferred**" means Series A get the greater of their $5m preference or what they would receive if they converted to common (i.e., 20% of $40m, or $8m).

  Result: $8m goes to the Series A; $32m goes to the common stock. (20%)

- A "**1X Participating Preferred with a 2X Cap**" means Series A get their $5m preference plus 20% of the remaining $35m up to a total 2X cap ($10m).

  Result: $10m goes to the Series A; $30m goes to the common stock. (25%)

- A "**1X Participating Preferred without a cap**" means Series A get their $5m preference (the "preferred") plus 20% of the remaining $35m, or $7m (the "participating").

  Result: $12m goes to the Series A; $28m goes to the common stock. (30%)

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Liquidation Preference – Take Aways

- Calculating Liquidation Preference gets VERY complicated, especially when multiple rounds of preferred are "stacked."
- Liquidation preference is almost <u>never</u> negotiable, but participating preferred is almost <u>always</u> is.
- Liquidation preference becomes less meaningful in very large exit events, and participating preferred can be meaningless in very small exit events.
- "Flat spots" can create divergent incentives
- Early round investors often regret having received very rich terms, as these set a precedent for later rounds.
- Only applicable in a "liquidation event." There are some "exits" (e.g. IPO) where preferred get converted to common, and liquidation preference becomes meaningless.

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Antidilution Protection

- Protects investors in a "down round" - when new money comes in at a pre-money valuation (or price per share) that is lower than the previous round's post-money valuation.
- Anti-dilution protection is triggered whenever company issues shares at a lower valuation
- Certain (critical) exceptions will not trigger the adjustment

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Antidilution Protection

- How does it work? At the beginning, preferred stock converts to common stock at a 1-for-1 ratio.
- When the anti-dilution protection is triggered, the conversion ratio is adjusted, resulting in the preferred stock getting more shares of common stock upon conversion.
- 2 Types: "Weighted Average" and "Full Ratchet"
- Don't fight the concept - focus on mitigating the impact (e.g. weighted average with broad list of exceptions)

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Dividends

- Another “debt-like” feature of preferred stock
- Automatic vs. declared
- Cumulative vs. non-cumulative
- Compounding vs. non-compounding
- Dividends matter more with disappointing investments than with home runs

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Control – Protective Provisions

- aka "Negative covenants," "Veto rights" or "blocking rights"
- Essentially a list of things you can't do without investors' prior consent

  - Consent at either the Board or Stockholder level
- Usually hotly negotiated
- This is a foot on the break, not on the accelerator
- Gets complicated in later rounds; interests of investors can diverge
- Dependent on retaining level of ownership?

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Control – Board Seats

- Usually investors require one or more board seats
- Challenge: What is proper balance between founders, investors (both existing and new), and outside directors?
- Keep board size manageable – bigger is not always better
- Sometimes a "board observer" rather than board seat

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Monitoring and Preserving Investment

- "Affirmative" Covenants
- Financial Reporting Requirements
- Rights to Financial Information and Access

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Maintaining / Increasing Equity Position

- Pre-emptive / Participation Rights (Company's stock)
  - Right to buy shares in future company financing
  - Major investors sometimes eat up unsubscribed shares
  - "Pay to Play"

- Rights of First Refusal (Founder's Stock)

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Liquidating Equity Position

- Drag-Along Rights (M&A)
  - triggered by required percentage of preferred
  - forces founders and common holders to vote in favor of deal
  - makes "dissenters rights" moot
- Tag-Along Rights (Co-sale with founder)
- Registration Rights (IPO)
- Redemption Rights

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Founders Restricted Stock

- Company has right to purchase "unvested" shares if founder's employment terminates
- Vesting usually 4 years, with one-year cliff
- Sometimes founders get "credit" for prior vesting, or a shorter vesting period
- Forfeited shares have "anti-dilutive" effect on all other equity
- Single and double trigger acceleration on change of control
- Possible tax complications

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A Word on Convertible Notes

- Automatic conversion on qualified financing
- Discounts are becoming increasingly common; sometimes coupled with a cap on valuation
- Paid or converted upon acquisition
- Interest Rate
- Maturity Date
- Collateral (secured or not)
- % needed to amend terms

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Final Thoughts

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Final Thoughts

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Final Thoughts

- Choose your legal advisors wisely. This stuff gets complicated fast. And do it early (before negotiating the term sheet!)
- Choose your investors wisely. All money is not created equal – their belief in you and your team is more important than their capital.
- Choose your fights wisely. Make sure you know what really matters to you, and understand the market dynamics. Don't be afraid to ask "why do you need that?"

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Other Resources

- www.emergingenterprisecenter.com:
  - Glossary (commonly used terms)
  - Ask the Startup Lawyers (common questions and answers; submit your questions!)
  - EEC Perspectives (our quarterly publication tracking terms of New England VC deals)
- NVCA Model Venture Capital Financing Documents (including model term sheet):
  - www.nvca.org (click "Resources" then "Model Legal Documents") or use http://bit.ly/bj7Pn
  - Forms are intended as starting point only

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Questions?

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