

Articles on Different Aspects of Term Sheets
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The following document contains blog entries on the following topics regarding term sheets:

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Term Sheet: Price

A the end of the year, I completed a financing that was much more difficult than it needed to be. As Jason Mendelson (our general counsel) and I were whining to each other we decided to do something about it. At the risk of giving away more super-top-secret VC magic tricks, we've decided to co-author a series of posts on Term Sheets.

We have chosen to address the most frequently discussed terms in a venture financing term sheet. The early posts in the series will be about terms that matter - as we go on, we'll get into the more arcane and/or irrelevant stuff (which - ironically - some VCs dig in and hold on to as though the health of their children depended on them getting the terms "just right.") The specific contract language that we refer to (usually in *italics*) will be from actual term sheets that are common in the industry. Ultimately, we might put this into a Wiki, but for now we'll just write individual posts. Obviously, feel free to comment freely (and critically.)

In general, there are only two things that venture funds really care about when doing investments: economics and control. The term "economics" refers to the end of the day return the investor will get and the terms that have direct impact on such return. The term "control" refers to mechanisms which allow the investors to either affirmatively exercise control over the business or allow the investor to veto certain decisions the company can make. If you are negotiating a deal and an investor is digging his or her feet in on a provision that doesn't affect the economics or control, they are probably blowing smoke, rather than elucidating substance.

Obviously the first term any entrepreneur is going to look at is the price. The pre-money and post-money terms are pretty easy to understand. The pre-money valuation is what the investor is valuing the company today, before investment, while the post-money valuation is simply the pre-money valuation plus the contemplated aggregate investment amount. There are two items to note within the valuation context: stock option pools and warrants.

Both the company and the investor will want to make sure the company has sufficiently reserved shares of equity to compensate and motivate its workforce. The bigger the pool the better, right? Not so fast. While a large option pool will make it less likely that the company runs out of available options, note that the size of the pool is taken into account in the valuation of the company, thereby effectively lowering the true pre-money

valuation. If the investor believes that the option pool of the company should be increased, they will insist that such increase happen prior to the financing. Don't bother to try to fight this, as nearly all VCs will operate this way. It is better to just negotiate a higher pre-money valuation if the actual value gives you heartburn. Standard language looks like this:

Amount of Financing: *An aggregate of \$ X million, representing a ___% ownership position on a fully diluted basis, including shares reserved for any employee option pool. Prior to the Closing, the Company will reserve shares of its Common Stock so that ___% of its fully diluted capital stock following the issuance of its Series A Preferred is available for future issuances to directors, officers, employees and consultants.*

Alternatively:

Price: *\$_____ per share (the Original Purchase Price). The Original Purchase Price represents a fully-diluted pre-money valuation of \$ ___ million and a fully-diluted post money valuation of \$___ million. For purposes of the above calculation and any other reference to fully-diluted in this term sheet, fully-diluted assumes the conversion of all outstanding preferred stock of the Company, the exercise of all authorized and currently existing stock options and warrants of the Company, and the increase of the Company's existing option pool by [] shares prior to this financing.*

Recently, another term that has gained popularity among investors is warrants associated with financings. As with the stock option allocation, this is another way to back door a lower valuation for the company. Warrants as part of a venture financing - especially in an early stage investment - tend to create a lot of unnecessary complexity and accounting headaches down the road. If the issue is simply one of price, we recommend the entrepreneur negotiate for a lower pre-money valuation to try to eliminate the warrants. Occasionally, this may be at cross-purposes with existing investors who - for some reason - want to artificially inflate the valuation since the warrant value is rarely calculated as part of the valuation (but definitely impacts the future allocation of proceeds in a liquidity event.) Note, that with bridge loan financings, warrants are commonplace as the bridge investor wants to get a lower price on the conversion of their bridge into the next round - it's not worth fighting these warrants.

The best way for an entrepreneur to negotiate price is to have multiple VCs interested in investing in his company - (economics 101: If you have more demand (VCs interested)

than supply (equity in your company to sell) then price will increase.) In early rounds, your new investors will likely be looking for the lowest possible price that still leaves enough equity in the founders and employees hands. In later rounds, your existing investors will often argue for the highest price for new investors in order to limit the existing investors dilution. If there are no new investors interested in investing in your company, your existing investors will often argue for an equal to (flat round) or lower than (down round) price than the previous round. Finally, new investors will always argue for the lowest price they think will enable them to get a financing done, given the appetite (or lack thereof) of the existing investors in putting more money into the company. As an entrepreneur, you are faced with all of these contradictory motivations in a financing, reinforcing the truism that it is incredibly important to pick your early investors wisely, as they can materially help or hurt this process.

Term Sheet: Liquidation Preference

I've written about liquidation preferences (and participating preferred) before, as have most of the other VC bloggers (and several entrepreneur bloggers.) However, for completeness, and since liquidation preferences are the second most important "economic term" (after price), Jason and I decided to write a post on it. Plus - if you read carefully - you might find some new and exciting super-secret VC tricks.

The liquidation preference determines how the pie is shared on a liquidity event. There are two components that make up what most people call the liquidation preference: the actual preference and participation. To be accurate, the term liquidation preference should only pertain to money returned to a particular series of the company's stock ahead of other series of stock. Consider for instance the following language:

Liquidation Preference: In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of the Common Stock a per share amount equal to [x] the Original Purchase Price plus any declared but unpaid dividends (the Liquidation Preference).

This is the actual preference. In the language above, a certain multiple of the original investment per share is returned to the investor before the common stock receives any consideration. For many years, a "1x" liquidation preference was the standard. Starting in 2001, investors often increased this multiple, sometimes as high as 10x! (Note, that it is mostly back to 1x today.)

The next thing to consider is whether or not the investor shares are participating. Again, note that many people consider the term “liquidation preference” to refer to both the preference and the participation, if any. There are three varieties of participation: full participation, capped participation and non-participating.

Fully participating stock will share in the liquidation proceeds on a pro rata basis with common after payment of the liquidation preference. The provision normally looks like this:

Participation: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on a common equivalent basis.

Capped participation indicates that the stock will share in the liquidation proceeds on a pro rata basis until a certain multiple return is reached. Sample language is below.

Participation: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on a common equivalent basis; provided that the holders of Series A Preferred will stop participating once they have received a total liquidation amount per share equal to [X] times the Original Purchase Price, plus any declared but unpaid dividends. Thereafter, the remaining assets shall be distributed ratably to the holders of the Common Stock.

One interesting thing to note in the section is the actual meaning of the multiple of the Original Purchase Price (the [X]). If the participation multiple is 3 (three times the Original Purchase Price), it would mean that the preferred would stop participation (on a per share basis) once 300% of its original purchase price was returned including any amounts paid out on the liquidation preference. This is not an additional 3x return, rather an additional 2x, assuming the liquidation preference were a 1 times money back return. Perhaps because of this correlation with the actual preference, the term liquidation preference has come to include both the preference and participation terms. If the series is not participating, it will not have a paragraph that looks like the ones above.

Liquidation preferences are usually easy to understand and assess when dealing with a series A term sheet. It gets much more complicated to understand what is going on as a

company matures and sells additional series of equity as understanding how liquidation preferences work between the series is often mathematically (and structurally) challenging. As with many VC-related issues, the approach to liquidation preferences among multiple series of stock varies (and is often overly complex for no apparent reason.) There are two primary approaches: (1) The follow-on investors will stack their preferences on top of each other: series B gets its preference first, then series A or (2) The series are equivalent in status (called *pari passu* - one of the few latin terms lawyers understand) so that series A and B share pro-ratably until the preferences are returned. Determining which approach to use is a black art which is influenced by the relative negotiating power of the investors involved, ability of the company to go elsewhere for additional financing, economic dynamics of the existing capital structure, and the phase of the moon.

Most professional, reasonable investors will not want to gouge a company with excessive liquidation preferences. The greater the liquidation preference ahead of management and employees, the lower the potential value of the management / employee equity. There's a fine balance here and each case is situation specific, but a rational investor will want a combination of "the best price" while insuring "maximum motivation" of management and employees. Obviously what happens in the end is a negotiation and depends on the stage of the company, bargaining strength, and existing capital structure, but in general most companies and their investors will reach a reasonable compromise regarding these provisions. Note that investors get either the liquidation preference and participation amounts (if any) or what they would get on a fully converted common holding, at their election; they do not get both (although in the fully participating case, the participation amount is equal to the fully converted common holding amount.)

Since we've been talking about liquidation preferences, it's important to define what a "liquidation" event is. Often, entrepreneurs think of a liquidation as simply a "bad" event - such as a bankruptcy or a wind down. In VC-speak, a liquidation is actually tied to a "liquidity event" where the shareholders receive proceeds for their equity in a company, including mergers, acquisitions, or a change of control of the company. As a result, the liquidation preference section determines allocation of proceeds in both good times and bad. Standard language looks like this:

A merger, acquisition, sale of voting control or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation.

Ironically, lawyers don't necessarily agree on a standard definition of the phrase "liquidity event." Jason once had an entertaining (and unenjoyable) debate during a guest lecture he gave at his alma mater law school with a partner from a major Chicago law firm (who was teaching a venture class that semester) that claimed an initial public offering should be considered a liquidation event. His theory was that an IPO was the same as a merger, that the company was going away, and thus the investors should get their proceeds. Even if such a theory would be accepted by an investment banker who would be willing to take the company public (no chance in our opinion), it makes no sense as an IPO is simply another funding event for the company, not a liquidation of the company. However, in most IPO scenarios, the VCs "preferred stock" is converted to common stock as part of the IPO, eliminating the issue around a liquidity event in the first place.

That's enough for now - I'm going to go get a drink and have my own personal liquidity event (sorry - the punmaster got control of my keyboard for a moment.)

Term Sheet: Board of Directors

In our series of posts on Term Sheets, Jason and I thought we'd take on a relatively easy one today. In our previous posts on Price and Liquidation Preferences, we discussed the key economic terms that VCs care about. In this post, we tackle one of the two primary "control terms" that matter to VCs.

VCs care about control provisions in order to keep an eye on their investment as well as – in some cases - comply with certain federal tax statutes that are a result of the types of investors that invest in VC funds. One of the key control mechanisms is the election of the board of directors.

There is no secret science in the board of director election paragraph – it simply spells out how the board of directors will be chosen. The entrepreneur should think carefully about what they believe the proper balance should be between investor, company, founder and outsider representation should be on the board. There are many existing VC (and entrepreneur) posts concerning the value of a board, the desired composition

of the board, and what a board is responsible for. This post doesn't delve into those issues - we are simply addressing how the board is selected.

A typical term sheet looks as follows:

Board of Directors: *The size of the Company's Board of Directors shall be set at [n]. The Board shall initially be comprised of _____, as the Investor representative[s] _____, _____, and _____. At each meeting for the election of directors, the holders of the Series A Preferred, voting as a separate class, shall be entitled to elect [x] member[s] of the Company's Board of Directors which director shall be designated by Investor, the holders of Common Stock, voting as a separate class, shall be entitled to elect [x] member[s], and the remaining directors will be [Option 1: mutually agreed upon by the Common and Preferred, voting together as a single class.] [or Option 2: chosen by the mutual consent of the Board of Directors].*

If a subset of the board is being chosen by more than one constituency (e.g., two directors chosen by the investors, two by founders / common holders and one by "mutual consent"), you should consider what is best: (a) chosen by mutual consent of the board (one person, one vote) or (b) voted upon on the basis of proportional share ownership on a common-as-converted basis.

VCs will often want to include a board observer as part of the agreement either instead of or in addition to an official member of the board. This is typical and usually helpful, as many VC partners have an associate that works with them on their companies. While there's rarely any contention about who attends a board meeting, most VCs will want the right to have another person from the firm at the board meeting, even if they are non-voting (an "observer").

Many investors will mandate that one of the common-stockholder chosen board members be the then-serving CEO of the company. This can be tricky if the CEO is the same as one of the key founders – often you'll see language giving the right to a board seat to one of the founders and a separate board seat to the then CEO – consuming two of the common board seats. Then – if the CEO changes, so does that board seat.

While it is appropriate for board member and observers to be reimbursed for their reasonable out-of-pocket costs for attending board meetings, we rarely see board

members receive cash compensation for serving on the board of a private company. Outside board members are usually compensated with stock options – just like key employees – and are often invited to invest money in the company alongside the VCs.

Term Sheet: Protective Provisions

As Jason and I continue to work our way through a typical venture capital term sheet, we encounter another key control term - the “protective provisions.” Protective provisions are effectively veto rights that investors have on certain actions by the company. Not surprisingly, these provisions protect the VC (unfortunately, not from himself.)

The protective provisions are often hotly negotiated. Entrepreneurs would like to see few or no protective provisions in their documents. VCs – in contrast – would like to have some veto-level control over a subset of actions the company could take, especially when it impacts the VC’s economic position.

A typical protective provision clause looks as follows:

***“Protective Provisions:** For so long as any shares of Series A Preferred remain outstanding, consent of the holders of at least a majority of the Series A Preferred shall be required for any action, whether directly or through any merger, recapitalization or similar event, that (i) alters or changes the rights, preferences or privileges of the Series A Preferred, (ii) increases or decreases the authorized number of shares of Common or Preferred Stock, (iii) creates (by reclassification or otherwise) any new class or series of shares having rights, preferences or privileges senior to or on a parity with the Series A Preferred, (iv) results in the redemption or repurchase of any shares of Common Stock (other than pursuant to equity incentive agreements with service providers giving the Company the right to repurchase shares upon the termination of services), (v) results in any merger, other corporate reorganization, sale of control, or any transaction in which all or substantially all of the assets of the Company are sold, (vi) amends or waives any provision of the Company’s Certificate of Incorporation or Bylaws, (vii) increases or decreases the authorized size of the Company’s Board of Directors, or (viii) results in the payment or declaration of any dividend on any shares of Common or Preferred Stock, or (ix) issuance of debt in excess of \$100,000.”*

Subsection (ix) is often the first thing that gets changed by raising the debt threshold to something higher, as long as the company is a real operating business rather than an early stage startup. Another easily accepted change is to add a minimum threshold of preferred shares outstanding for the protective provisions to apply, keeping the protective provisions from “lingering on forever” when the capital structure is changed – either through a positive or negative event.

Many company counsels will ask for “materiality qualifiers” (e.g. that the word “material” or “materially” be inserted in front of subsections (i), (ii) and (vi), above.) We always decline this request, not to be stubborn (ok – sometimes to be stubborn), but because we don’t really know what “material” means (if you ask a judge, or read any case law, they will not help you either) and we believe that specificity is more important than debating reasonableness. Remember – these are protective provisions – they don’t “eliminate” the ability to do these things – they simply require consent of the investors. As long as things are “not material” from the VC’s point of view, the consent to do these things will be granted. We’d always rather be clear up front what the rules of engagement are, rather than having a debate over “what material means” in the middle of a situation where these protective provisions might come into play.

When future financing rounds occur (e.g. Series B – a new “class” of preferred stock), there is always a discussion as to how the protective provisions will work with regard to the new financing. There are two cases: (a) the Series B gets its own protective provisions or (b) the Series B investors vote alongside the original investors as a single class. Entrepreneurs almost always will want a single vote for all the investors (case b), as the separate investor class protective provision vote means the company now has two classes of potential veto constituents to deal with. Normally new investors will ask for a separate vote, as their interests may diverge from those of the original investors due to different pricing, different risk profiles, and a false need for overall control. However, many experienced investors will align with the entrepreneur’s point of view of not wanting separate class votes as they do not want the potential headaches of another equity class vetoing an important company action. If your Series B investors are the same as your Series A investors, this is an irrelevant discussion, and it should be easy for everyone to default to case b. If you have new investors in the Series B, be wary of inappropriate veto rights for small investors (e.g. consent percentage required is 90% instead of a majority (50.1%), so a new investor who only owns 10.1% of the financing can effectively assert control over the protective provisions through his vote.)

Some investors that feel they have enough control with their board involvement to ensure the company does not take any action contrary to their interests, and as a result will not focus on these protective provisions. During a financing, this is the typical argument used by company counsel to try to convince the VCs to back off of some or all of the protective provisions. We think this is a short-sighted approach for the investor, for as a board member, an investor designee has legal duties to work in the best interests of the company. Sometimes the interests of the company and a particular class of shareholders diverge. Therefore, there can be times whereby an individual would legally have to approve something as a board member in the best interests of the company as a whole and not have a protective provision to fall back on as a shareholder. While this dynamic does not necessarily “benefit” the entrepreneur, it’s good governance, as it functionally separates the duties of a board member from that of a shareholder, shining a clearer lens on a area of potential conflict.

While one could make the argument that protective provisions are at the core of the “trust” between a VC and entrepreneur, we think that’s a hollow and inappropriate statement. When an entrepreneur asks “don’t you trust me - why do we need these things?”, the simple answer is that it is not an issue of trust. Rather, we like to eliminate the discussion about who ultimately gets to make which decisions before we do a deal. Eliminating the ambiguity in roles, control, and rules of engagement is an important part of any financing – the protective provisions cut to the heart of some of this.

Term Sheet: Drag Along

As Jason and I continue to wind our way through a typical VC term sheet, we thought we’d tackle the infamous “drag-along agreement.” This is one of those terms that has recently increased in importance to VCs due to the all the financing and exit dynamics that occurred during the downturn of 2001 – 2003. A typical drag-along agreement is short and sweet and looks as follows:

“Drag-Along Agreement: *The [holders of the Common Stock] or [Founders] and Series A Preferred shall enter into a drag-along agreement whereby if a majority of the holders of Series A Preferred agree to a sale or liquidation of the Company, the holders of the remaining Series A Preferred and Common Stock shall consent to and raise no objections to such sale.”*

As transactions started occurring that were at or below the preferred liquidation preferences, entrepreneurs and founders – not surprisingly – started to resist doing these transactions since they often weren't getting anything in the deal. While there are several mechanisms to address sharing consideration below the liquidation preferences (e.g. the "carve out" - which we'll talk more extensively about some other time), the fundamental issue is that if a transaction occurs below the liquidation preferences, it's likely that some or all of the VCs are losing money on the transaction. The VC point of view on this varies widely (and is often dependent on the situation) – some VCs can deal with this and are happy to provide some consideration to management to get a deal done; others are stubborn in their view that since they lost money, management shouldn't receive anything.

However, in all of these situations, the VCs would much rather control their ability to compel other shareholders to support the transaction being considered. As more of these situations appeared, the major holders of common stock (even when they were in the minority of ownership) began refusing to vote for the proposed transaction unless the holders of preferred waived part of their liquidation preferences in favor of the common. Needless to say, this "hold out technique" did not go over well in the venture community and, as a result, the drag-along became more prevalent.

I've heard founders and early shareholders say a variety of things with regard to a drag-along, but the most inane is "it's not fair – I want to be able to vote my stock however I want to." Remember that this term is one of a basket of terms that are part of an overall negotiation associated with injecting money into your company. There are tradeoffs in any negotiation and nothing is standard – so "fair" is an irrelevant concept – if you don't like the terms, don't do the deal.

If you are faced with a drag-along, your ownership position will determine whether or not this is a relevant issue for you. An M&A transaction does not require unanimous consent of shareholders (these rules vary by jurisdiction, although the two most common situations are either majority of each class (California) or majority of all shares on an as converted basis (Delaware)), although most acquirers will want 85% to 90% of shareholders to consent to a transaction. So – if you own 1% of a company, while the VCs would like you to sign up to a drag-along, it doesn't matter that much (unless there are 30 of you that own 1%.) Again – make sure you know what you are fighting for in the negotiation – don't put disproportionate energy against terms that don't matter.

When a company is faced with a drag along in a VC financing proposal, the most common compromise position is to try to get the drag along to pertain to following the majority of the common stock, not the preferred. This way – if you own common – you are only dragged along when a majority of the common consents to the transaction. This is a graceful position for a very small investor to take (e.g. I'll play ball if a majority of the common plays ball) and one that I've always been willing to take when I've owned common in a company (e.g. I'm not going to stand in the way of something a majority of folks that have rights equal to me want to do.) Of course, preferred investors can always convert some of their holding to common to generate a majority, but this also results in a benefit to the common as it lowers the overall liquidation preference.

Term Sheet - Anti-Dilution

It has been a while since I put up a term sheet post so I thought I'd tackle a hard one today. While it's fun to tease lawyers about math (and – actually – about anything), my co-author on this series Jason Mendelson (a lawyer) often reminds me that lawyers can do basic arithmetic (and occasionally have to resort to algebra). The *anti-dilution* provision demonstrates this point.

Traditionally, the anti-dilution provision is used to protect investors in the event a company issues equity at a lower valuation than in previous financing rounds. There are two varieties: weighted average anti-dilution and ratchet based anti-dilution. Standard language is as follows:

Anti-dilution Provisions: *The conversion price of the Series A Preferred will be subject to a [full ratchet / broad-based / narrow-based weighted average] adjustment to reduce dilution in the event that the Company issues additional equity securities (other than shares (i) reserved as employee shares described under the Company's option pool,, (ii) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board; (iii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement or debt financing from a bank or similar financial institution approved by the Board; and (iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their anti-dilution rights) at a purchase price less than the applicable conversion price. In the event of an issuance of stock involving tranches or other multiple closings, the antidilution adjustment shall be calculated as if*

all stock was issued at the first closing. The conversion price will also be subject to proportional adjustment for stock splits, stock dividends, combinations, recapitalizations and the like.

Full ratchet means that if the company issues shares at a price lower than the Series A, then the Series A price is effectively reduced to the price of the new issuance. One can get creative and do “partial ratchets” (such as “half ratchets” or “two-thirds ratchets”) which are a less harsh, but rarely seen.

While full ratchets came into vogue in the 2001 – 2003 time frame when down-rounds were all the rage, the most common anti-dilution provision is based on the weighted average concept, which takes into account the magnitude of the lower-priced issuance, not just the actual valuation. In a “full ratchet world” if the company sold one share of its stock to someone for a price lower than the Series A, all of the Series A stock would be repriced to the issuance price. In a “weighted average world,” the number of shares issued at the reduced price are considered in the repricing of the Series A.

Mathematically (and this is where the lawyers get to show off their math skills – although you’ll notice there are no exponents or summation signs anywhere) it works like this (note that despite the fact one is buying preferred stock, the calculations are always done in as-if-converted to common stock basis):

$$\text{NCP} = \text{OCP} * ((\text{CSO} + \text{CSP}) / (\text{CSO} + \text{CSAP}))$$

Where:

- NCP = new conversion price
- OCP = old conversion price
- CSO = common stock outstanding
- CSP = common stock purchasable with consideration received by company (i.e. “what the buyer should have bought if it hadn’t been a ‘down round’ issuance”)
- CSAP = common stock actually purchased in subsequent issuance (i.e., “what the buyer actually bought”)

Recognize that we are determining a “new conversion price” for the Series A Preferred . We are not actually issuing more shares (you can do it this way, but it’s a silly and unnecessarily complicated approach that merely increases the amount the lawyers can

bill the company for the financing). Consequently, “anti-dilution provisions” generate a “conversion price adjustment” and the phrases are often used interchangeably.

Got it? I find it’s best to leave the math to the lawyers.

You might note the term “broad-based” in describing weighted average anti-dilution. What makes the provision a broad-based versus narrow-based is the definition of “common stock outstanding” (CSO). A broad-based weighted average provision includes both the company’s common stock outstanding (including all common stock issuable upon conversion of its preferred stock) as well as the number of shares of common stock which could be obtained by converting all other options, rights, and securities (including employee options). A narrow-based provision will not include these other convertible securities and limit the calculation to only currently outstanding securities. The number of shares and how you count them matter – make sure you are agreeing on the same definition (you’ll often find different lawyers arguing over what to include or not include in the definitions – again – this is another common legal fee inflation technique).

In our example language, we’ve included a section which is generally referred to as “anti-dilution carve outs” (the section *(other than shares (i) ... (iv))*). These are the standard exceptions for share granted at lower prices for which anti-dilution does not kick in. Obviously - from a company (and entrepreneur) perspective - more exceptions are better – and most investors will accept these carve-outs without much argument.

One particular item to note is the last carve out: *(iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their anti-dilution rights*. This is a carve out that started appearing recently which we have found to be very helpful in deals where a majority of the Series A investors agree to further fund a company in a follow-on financing, but the price will be lower than the original Series A. In this example, several minority investors signaled they were not planning to invest in the new round, as they would have preferred to “sit back” and increase their ownership stake via the anti-dilution provision. Having the larger investors (the majority of the class) “step up” and vote to carve the financing out of the anti-dilution terms was a huge bonus for the company common holders and employees who would have suffered the dilution of additional anti-dilution from investors who were not continuing to participate in

financing the company. This approach encourages the minority investors to participate in the round in order to protect themselves from dilution.

Occasionally, anti-dilution will be absent in a Series A term sheet. Investors love precedent (e.g. the new investor says “I want what the last guy got, plus more”). In many cases anti-dilution provisions hurt Series A investors more than prior investors if you assume the Series A price is the low watermark for the company. For instance, if the Series A price is \$1.00, the Series B price is \$5.00, and the Series C price is \$3.00, then the Series B is benefited by an anti-dilution provision at the expense of the Series A. However, our experience is that anti-dilution is usually requested despite this as Series B investors will most likely always ask for it and – since they do – the Series A proactively asks for it anyway.

In addition to economic impacts, anti-dilution provisions can have control impacts. First, the existence of an anti-dilution provision incents the company to issue new rounds of stock at higher valuations because of the ramifications of anti-dilution protection to the common stock holders. In some cases, a company may pass on taking an additional investment at a lower valuation (although practically speaking, this only happens when a company has other alternatives to the financing). Second, a recent phenomenon is to tie anti-dilution calculations to milestones the investors have set for the company resulting in a conversion price adjustment in the case that the company does not meet certain revenue, product development or other business milestones. In this situation, the anti-dilution adjustments occur automatically if the company does not meet in its objectives, unless this is waived by the investor after the fact. This creates a powerful incentive for the company to accomplish its investor-determined goals. We tend to avoid this approach, as blindly hitting pre-determined (at the time of financing) product and sales milestones is not always best for the long-term development of a company, especially if these goals end up creating a diverging set of goals between management and the investors as the business evolves.

Anti-dilution provisions are almost always part of a financing, so understanding the nuances and knowing which aspects to negotiate is an important part of the entrepreneur’s toolkit. We advise you not to get hung up in trying to eliminate anti-dilution provisions – rather focus on (a) minimizing their impact and (b) building value in your company after the financing so they don’t ever come into play.

Term Sheet: Pay-to-Play

There's nothing like a solid week of vacation with no phone, email, or blogs to get the writing juices rolling again. Of course, now that I'm through my email, I only have 8200 blog posts to read to catch up – thank god for jet lag – wait, what am I saying?

In our term sheet series, Jason Mendelson and I have been focusing first on “the terms that really matter.” We are down to the last one – *the pay-to-play provision*. At the turn of the century, a pay-to-play provision was rarely seen. After the bubble burst in 2001, it became ubiquitous. Interesting, this is a term that most companies and their investors can agree on if they approach it from the right perspective.

In a pay-to-play provision, an investor must keep “paying” (participating pro ratably in future financings) in order to keep “playing”(not have his preferred stock converted to common stock) in the company. Sample language follows:

“Pay-to-Play: *In the event of a Qualified Financing (as defined below), shares of Series A Preferred held by any Investor which is offered the right to participate but does not participate fully in such financing by purchasing at least its pro rata portion as calculated above under “Right of First Refusal” below will be converted into Common Stock.*

[(Version 2, which is not quite as aggressive): If any holder of Series A Preferred Stock fails to participate in the next Qualified Financing, (as defined below), on a pro rata basis (according to its total equity ownership immediately before such financing) of their Series A Preferred investment, then such holder will have the Series A Preferred Stock it owns converted into Common Stock of the Company. If such holder participates in the next Qualified Financing but not to the full extent of its pro rata share, then only a percentage of its Series A Preferred Stock will be converted into Common Stock (under the same terms as in the preceding sentence), with such percentage being equal to the percent of its pro rata contribution that it failed to contribute.]

A Qualified Financing is the next round of financing after the Series A financing by the Company that is approved by the Board of Directors who determine in good faith that such portion must be purchased pro rata among the stockholders of the Company

subject to this provision. Such determination will be made regardless of whether the price is higher or lower than any series of Preferred Stock.

When determining the number of shares held by an Investor or whether this “Pay-to-Play” provision has been satisfied, all shares held by or purchased in the Qualified Financing by affiliated investment funds shall be aggregated. An Investor shall be entitled to assign its rights to participate in this financing and future financings to its affiliated funds and to investors in the Investor and/or its affiliated funds, including funds which are not current stockholders of the Company.”

We believe this is good for the company and its investors as it causes the investors “stand up” and agree to support the company during its lifecycle at the time of the investment. If they do not, the stock they have is converted from preferred to common and they lose the rights associated with the preferred stock. When our co-investors push back on this term, we ask: “Why? Are you not going to fund the company in the future if other investors agree to?” Remember, this is not a lifetime guarantee of investment, rather if other prior investors decide to invest in future rounds in the company, there will be a strong incentive for all of the prior investors to invest or subject themselves to total or partial conversion of their holdings to common stock. A pay-to-play term insures that all the investors agree in advance to the “rules of engagement” concerning participating in future financings.

The pay-to-play provision impacts the economics of the deal by reducing liquidation preferences for the non-participating investors. It also impacts the control of the deal, as it reshuffles the future preferred shareholder base by insuring only the committed investors continue to have preferred stock (and the corresponding rights).

When companies are doing well, the pay-to-play provision is often waived, as a new investor wants to take a large part of the new round. This is a good problem for a company to have, as it typically means there is an up-round financing, existing investors can help drive company-friendly terms in the new round, and the investor syndicate increases in strength by virtue of new capital (and – presumably – another helpful co-investor) in the deal.

Term Sheet: Dividends

As our term sheet series unfolds (almost as exciting as 24, eh? – if you’ve been reading the last few days I bet you figured out that I recently had a 7 hour plane ride with a laptop battery that was in pretty good shape) we now shift gears from nuclear meltdown situations (also known as “things that matter a lot”) to economic terms that can matter, but aren’t as important (e.g. “why doesn’t Kim have a job at CTU anymore?”)

Dividends are up first. While private equity guys love dividends (e.g. I guarantee you that when Bain Capital buys the NHL and renames it the “BHL”, the deal will have dividends in it), many venture capitalists – especially early stage ones - don’t really care about dividends (although some do – especially those that come from a pure financial focus and have never had a 50x+ return on anything). Typical dividend language in a term sheet follows:

*“**Dividends:** The holders of the Series A Preferred shall be entitled to receive [non-cumulative dividends in preference to any dividend on the Common Stock at the rate of [8%] of the Original Purchase Price per annum[, when and as declared by the Board of Directors]. The holders of Series A Preferred also shall be entitled to participate pro rata in any dividends paid on the Common Stock on an as-if-converted basis.”*

For early stage investments, dividends generally do not provide “venture returns” – they are simply modest juice in a deal. Let’s do some simple math. Assume a typical dividend of 10% (dividends will range from 5% to 15% depending on how aggressive your investor is – we picked 10% to make the math easy). Now – assume that you are an early stage VC (painful and yucky – we understand – just try for a few minutes). Success is not a 10% return – success is a 10x return. Now, assume that you (as the VC) have negotiated hard and gotten a 10% cumulative (you get the dividend every year, not only when they are declared), automatic (they don’t have to be declared, they happen automatically), annual dividend. Again – to keep the math simple – let’s assume the dividend does not compound – so every year you simply get 10% of your investment as a dividend. In this case, it will take you 100 years to get your 10x return. Since a typical venture deal lasts 5 to 7 years (and you’ll be dead in 100 years anyway), you’ll never see the 10x return from the dividend.

Now – assume a home run deal – assume a 50x return on a \$10m investment in five years. Even with a 10% cumulative annual dividend, this only increases the investor return from \$500m to \$505m (the annual dividend is \$1m (10% of \$10m) times 5 years).

So – while the juice from the dividend is nice, it doesn't really move the meter in the success case – especially since venture funds are typically 10 years long – meaning as a VC you'll only get 1x your money in a dividend if you invest on day 1 of a fund and hold the investment for 10 years. (NB to budding early stage VCs – don't raise your fund on the basis of your future dividend stream from your investments).

This also assumes the company can actually pay out the dividend – often the dividends can be paid in either stock or cash – usually at the option of the company. Obviously, the dividend could drive additional dilution if it is paid out in stock, so this is the one case where it is important not to get head faked by the investor (e.g. the dividend simply becomes another form of anti-dilution protection – although in this case one that is automatic and simply linked to the passage of time).

Of course – we're being optimistic about the return scenarios. In downside cases, the juice can matter, especially as the invested capital increases. For example, take a \$40m investment with a 10% annual cumulative dividend in a company that was sold at the end of the fifth year to another company for \$80m. In this case, assume that there was a straight liquidation preference (e.g. no participating preferred) and the investor got 40% of the company for her investment (or a \$100m post money valuation). Since the sale price was below the investment post money valuation (e.g. a loser, but not a disaster), the investor will exercise the liquidation preference and take the \$40m plus the dividend (\$4m per year for 5 years – or \$20m). In this case, the difference between the return in a no dividend scenario (\$40m) and a dividend scenario (\$60m) is material.

Mathematically, the larger the investment amount and the lower the expected exit multiple, the more the dividend matters. This is why you see dividends in private equity and buyout deals, where big money is involved (typically greater than \$50m) and the expectation for return multiples on invested capital are lower.

Automatic dividends have some nasty side effects, especially if the company runs into trouble, as they typically should be included in the solvency analysis and – if you aren't paying attention – an automatic cumulative dividend can put you unknowingly into the zone of insolvency (a bad place – definitely one of Dante's levels – but that's for another post).

Cumulative dividends can also be annoying and often an accounting nightmare, especially when they are optionally in stock, cash, or a conversion adjustment, but that's why the

accountants get paid the big bucks at the end of the year to put together the audited balance sheet.

That said, the non-cumulative when declared by the board dividend is benign, rarely declared, and an artifact of the past, so we typically leave it in term sheets just to give the lawyers something to do.

Term Sheet: Redemption Rights

If you are avid followers of the TV series 24 (as Jason and I are), you'll recognize that the next item in our term sheet series – *Redemption at Option of Investors* – has similar characteristics to the regular exchange Jack has with CTU:

CTU Director (any of them – Driscoll, Tony, Ryan, George, Michelle): “Jack – stand down – don't go in there without backup.”

Jack: (Gruffly, in a hoarse voice) “I gotta go in – there's no time to wait – if I don't go, the world will end and my (current babe, hostage, daughter, partner) will die.”

CTU Director: (Mildly panicked) “Jack – wait – it's too dangerous – I command you – wait.”

Jack: (Insolently) “I gotta go.” (Jack hangs up the phone).

Cut to clock ticking and commercial or teaser for scenes from next week.

Think of the discussion around redemption rights as this scene – utterly predictable and ultimately benign. Jack always goes in. Jack always stops the bad stuff – for the time being. Jack (or the bad guys) always creates a new problem. The CTU director always forgets that Jack disobeyed a direct order shortly after Jack is successful with his latest task.

You are Jack. Your investor is the CTU director. If you ask your CTU director “have you ever actually ever triggered redemption rights?” you will normally get some nervous fidgeting (“wait – it's too dangerous”), a sheepish “no” followed by a confident “but we have to have them or we won't do the deal!” (“I command you – wait.”)

Redemption rights usually look something like:

“Redemption at Option of Investors: *At the election of the holders of at least majority of the Series A Preferred, the Company shall redeem the outstanding Series A Preferred in three annual installments beginning on the [fifth] anniversary of the Closing. Such redemptions shall be at a purchase price equal to the Original Purchase Price plus declared and unpaid dividends.”*

There is some rationale for redemption rights. First, there is the “fear” (on the VCs part) that a company will become successful enough to be an on-going business, but not quite successful enough to go public or be acquired. In this case, redemption rights were invented to allow the investor a guaranteed exit path. However, any company that is around for a while as a going concern that is not an attractive IPO or acquisition candidate will not generally have the cash to pay out redemption rights.

The second reason for redemption rights pertains to the life span of venture funds. The average venture fund has a 10 years life span to conduct its business. If a VC makes an investment in year 5 of the fund, it might be important for that fund manager to secure redemption rights in order to have a liquidity path before his fund must wind down. As with the previous case, whether or not the company has the ability to pay is another matter.

Often, companies will claim that redemption rights create a liability on their balance sheet and can make certain business optics more difficult. In the past few years, accountants have begun to argue more strongly that redeemable preferred stock is a liability on the balance sheet, not an equity feature. Unless the redeemable preferred stock is *mandatorily redeemable*, this is not the case and most experienced accountants will be able to recognize the difference.

There is one form of redemption that we have seen in the past few years and we view as overreaching – the *adverse change redemption*. We recommend you never agree to the following which has recently crept into terms sheets.

“Adverse Change Redemption: *Should the Company experience a material adverse change to its prospects, business or financial position, the holders of at least majority of the Series A Preferred shall have the option to commit the Company to immediately redeem the outstanding Series A Preferred. Such redemption shall be at a purchase price equal to the Original Purchase Price plus declared and unpaid dividends.”*

This is just too vague, too punitive, and shifts an inappropriate amount of control to the investors based on an arbitrary judgment. If this term is being proposed and you are getting pushback on eliminating it, make sure you are speaking to a professional investor and not a loan shark.

In our experience – just like Jack’s behavior - redemption rights are well understood by the market and should not create a problem, except in a theoretical argument between lawyers or accountants.

Term Sheet: Conversion

While lots of VCs posture during term sheet negotiations by saying “that is non-negotiable”, terms rarely are (as you’ve likely inferred from previous posts on term sheets be me and Jason.) Occasionally, a term will actually be non-negotiable. In all the VC deals we’ve ever seen, the preferred has the right - at any time - to convert its stake into common. Following is the standard language:

“Conversion: *The holders of the Series A Preferred shall have the right to convert the Series A Preferred, at any time, into shares of Common Stock. The initial conversion rate shall be 1:1, subject to adjustment as provided below.*”

This allows the buyer of preferred to convert to common should he determine on a liquidation that he is better off getting paid on a pro rata common basis rather than accepting the liquidation preference and participating amount. It can also be used in certain extreme circumstances whereby the preferred wants to control a vote of the common on a certain issue. Do note, however, that once converted, there is no provision for “re-converting” back to preferred.

A more interesting term is the *automatic conversion*, especially since it has several components that are negotiable.

“Automatic Conversion: *All of the Series A Preferred shall be automatically converted into Common Stock, at the then applicable conversion price, upon the closing of a firmly underwritten public offering of shares of Common Stock of the Company at a per share price not less than [three] times the Original Purchase Price (as adjusted for stock splits, dividends and the like) per share and for a total offering of not less than [\$15] million (before deduction of underwriters commissions and expenses) (a “Qualified IPO”). All,*

or a portion of, each share of the Series A Preferred shall be automatically converted into Common Stock, at the then applicable conversion price in the event that the holders of at least a majority of the outstanding Series A Preferred consent to such conversion.”

In an IPO of a venture-backed company, the investment bankers will want to see everyone convert into common stock at the time of the IPO (it is extremely rare for a venture backed company to go public with multiple classes of stock – it happens – but it’s rare). The thresholds of the automatic conversion are critical to negotiate – as the entrepreneur; you want them lower to insure more flexibility while your investors will want them higher to give them more control over the timing and terms of an IPO.

Regardless of the actual thresholds, one thing of crucial importance is to never allow investors to negotiate different automatic conversion terms for different series of preferred stock. There are many horror stories of companies on the brink of going public and having one class of preferred stockholders that have a threshold above what the proposed offering would consummate and therefore these stockholders have an effective veto right on the offering. We strongly recommend that – at each financing – you equalize the automatic conversion threshold among all series of stock.

Term Sheet: Conditions Precedent to Financing

As I watched 24 last night, I kept thinking to myself “Why the fuck does Jack have his cell phone ringer on - hasn’t he ever heard of vibrate?” immediately after his cell phone rang but right before he got shot at because the bad guys now knew where he was. I had a parallel thought this morning - “Why do we make all this term sheet stuff so long, verbose, and tedious.” The answer - word processors. If we had to type all this crap on a typewriter (or write it out by hand) it’d be a lot shorter. In both cases, technology is working against us. But - then again, we wouldn’t have blogs (and I can hear a few of you (and I know who you are) saying “and that would be a bad thing because?”)

While there is a lot to negotiate in a term sheet (as you can see from the series of posts on term sheets that Jason and I have written), a term sheet is simply a step on the way to an actual deal. Term sheets are often either non-binding (or mostly non-binding), and most investors will load them up with *conditions precedent to financing*. Entrepreneurs glance over these – usually because they are in the back sections of the term sheet and

are typically pretty innocuous, but they occasionally have additional “back door outs” for the investor that the entrepreneur should watch out for, if only to better understand the current mindset of the investor proposing the investment.

A typical *conditions precedent to financing* clause looks as follows:

“Conditions Precedent to Financing: *Except for the provisions contained herein entitled “Legal Fees and Expenses”, “No Shop Agreement”, and “Governing Law” which are explicitly agreed by the Investors and the Company to be binding upon execution of this term sheet, this summary of terms is not intended as a legally binding commitment by the Investors, and any obligation on the part of the Investors is subject to the following conditions precedent: 1. Completion of legal documentation satisfactory to the prospective Investors; 2. Satisfactory completion of due diligence by the prospective Investors; 3. Delivery of a customary management rights letter to Investors; and 4. Submission of detailed budget for the following twelve months, acceptable to Investors.”*

Notice that the investor will try to make a few things binding – specifically (a) that his legal fees get paid whether or not a deal happens, (b) that the company can’t shop the deal once the term sheet is signed, and (c) that the governing law be set to a specific domicile – while explicitly stating “there are a bunch of things that still have to happen before this deal is done and I can back out for any reason.”

There are a few conditions to watch out for since they usually signal something non-obvious on the part of the investor. They are:

1. “Approval by Investors’ partnerships” – this is super secret VC code for “this deal has not been approved by the investors who issued this term sheet. Therefore, even if you love the terms of the deal, you still may not have a deal.
2. “Rights offering to be completed by Company” – this indicates that the investors want the company to offer all previous investors in the company the ability to participate in the currently contemplated financing. This is not necessarily a bad thing – in fact in most cases this serves to protect all parties from liability - but does add time and expense to the deal.

3. “Employment Agreements signed by founders as acceptable to investors” – beware what the full terms are before signing the agreement. As an entrepreneur, when faced with this, it’s probably wise to understand (and negotiate) the form of employment agreement early in the process. While you’ll want to try to do this before you sign a term sheet and accept a no-shop, most VCs will wave you off and say “don’t worry about it – we’ll come up with something that works for everyone.” Our suggestion – at the minimum, make sure you understand the key terms (such as compensation and what happens on termination).

There are plenty of other wacky conditionals – if you can dream it, it has probably been done. Just make sure to look carefully at this paragraph and remember that just because you’ve signed a term sheet, you don’t have a deal.

Term Sheet - Vesting

When Jason and I last wrote on the mythical term sheet, we were working our way through the terms that “can matter.” The last one on our list is vesting, and we approach it with one eyebrow raised understanding the impact of this term is crucial for all founders of an early stage company.

While vesting is a simple concept, it can have profound and unexpected implications. Typically, stock and options will vest over four years - which means that you have to be around for four years to own all of your stock or options (for the rest of this post, I’ll simply refer to the equity as “stock” although exactly the same logic applies to options.) If you leave the company earlier than the four year period, the vesting formula applies and you only get a percentage of your stock. As a result, many entrepreneurs view vesting as a way for VCs to “control them, their involvement, and their ownership in a company” which, while it can be true, is only a part of the story.

A typical stock vesting clause looks as follows:

Stock Vesting: *All stock and stock equivalents issued after the Closing to employees, directors, consultants and other service providers will be subject to vesting provisions below unless different vesting is approved by the majority (including at least one director designated by the Investors) consent of the Board of Directors (the “Required*

Approval”): 25% to vest at the end of the first year following such issuance, with the remaining 75% to vest monthly over the next three years. The repurchase option shall provide that upon termination of the employment of the shareholder, with or without cause, the Company or its assignee (to the extent permissible under applicable securities law qualification) retains the option to repurchase at the lower of cost or the current fair market value any unvested shares held by such shareholder. Any issuance of shares in excess of the Employee Pool not approved by the Required Approval will be a dilutive event requiring adjustment of the conversion price as provided above and will be subject to the Investors’ first offer rights.

*The outstanding Common Stock currently held by _____ and _____ (the “Founders”) will be subject to similar vesting terms provided that the Founders shall be credited with **[one year]** of vesting as of the Closing, with their remaining unvested shares to vest monthly over three years.*

Industry standard vesting for early stage companies is a one year cliff and monthly thereafter for a total of 4 years. This means that if you leave before the first year is up, you don’t vest any of your stock. After a year, you have vested 25% (that’s the “cliff”). Then - you begin vesting monthly (or quarterly, or annually) over the remaining period. So - if you have a monthly vest with a one year cliff and you leave the company after 18 months, you’ll have vested 37.25% of your stock.

Often, founders will get somewhat different vesting provisions than the balance of the employee base. A common term is the second paragraph above, where the founders receive one year of vesting credit at the closing and then vest the balance of their stock over the remaining 36 months. This type of vesting arrangement is typical in cases where the founders have started the company a year or more earlier than the VC investment and want to get some credit for existing time served.

Unvested stock typically “disappears into the ether” when someone leaves the company. The equity doesn’t get reallocated - rather it gets “reabsorbed” - and everyone (VCs, stock, and option holders) all benefit ratably from the increase in ownership (or - more literally - the reverse dilution.”) In the case of founders stock, the unvested stuff just vanishes. In the case of unvested employee options, it usually goes back into the option pool to be reissued to future employees.

A key component of vesting is defining what happens (if anything) to vesting schedules upon a merger. “Single trigger” acceleration refers to automatic accelerated vesting upon a merger. “Double trigger” refers to two events needing to take place before accelerated vesting (e.g., a merger plus the act of being fired by the acquiring company.) Double trigger is much more common than single trigger. Acceleration on change of control is often a contentious point of negotiation between founders and VCs, as the founders will want to “get all their stock in a transaction - hey, we earned it!” and VCs will want to minimize the impact of the outstanding equity on their share of the purchase price. Most acquires will want there to be some forward looking incentive for founders, management, and employees, so they usually either prefer some unvested equity (to help incent folks to stick around for a period of time post acquisition) or they’ll include a separate management retention incentive as part of the deal value, which comes off the top, reducing the consideration that gets allocated to the equity ownership in the company. This often frustrates VCs (yeah - I hear you chuckling “haha - so what?”) since it puts them at cross-purposes with management in the M&A negotiation (everyone should be negotiating to maximize the value for all shareholders, not just specifically for themselves.) Although the actual legal language is not very interesting, it is included below.

*In the event of a merger, consolidation, sale of assets or other change of control of the Company and should an Employee be terminated without cause within one year after such event, such person shall be entitled to **[one year]** of additional vesting. Other than the foregoing, there shall be no accelerated vesting in any event.”*

Structuring acceleration on change of control terms used to be a huge deal in the 1990’s when “pooling of interests” was an accepted form of accounting treatment as there were significant constraints on any modifications to vesting agreements. Pooling was abolished in early 2000 and - under purchase accounting - there is no meaningful accounting impact in a merger of changing the vesting arrangements (including accelerating vesting). As a result, we usually recommend a balanced approach to acceleration (double trigger, one year acceleration) and recognize that in an M&A transaction, this will often be negotiated by all parties. Recognize that many VCs have a distinct point of view on this (e.g. some folks will NEVER do a deal with single trigger acceleration; some folks don’t care one way or the other) - make sure you are not

negotiating against and “point of principle” on this one as VCs will often say “that’s how it is an we won’t do anything different.”

Recognize that vesting works for the founders as well as the VCs. I’ve been involved in a number of situations where one or more founders didn’t work out and the other founders wanted them to leave the company. If there had been no vesting provisions, the person who didn’t make it would have walked away with all their stock and the remaining founders would have had no differential ownership going forward. By vesting each founder, there is a clear incentive to work your hardest and participate constructively in the team, beyond the elusive founders “moral imperative.” Obviously, the same rule applies to employees - since equity is compensation and should be earned over time, vesting is the mechanism to insure the equity is earned over time.

Of course, time has a huge impact on the relevancy of vesting. In the late 1990’s, when companies often reached an exit event within two years of being founded, the vesting provisions - especially acceleration clauses - mattered a huge amount to the founders. Today - as we are back in a normal market where the typical gestation period of an early stage company is five to seven years, most people (especially founders and early employees) that stay with a company will be fully (or mostly) vested at the time of an exit event.

While it’s easy to set vesting up as a contentious issue between founders and VCs, we recommend the founding entrepreneurs view vesting as an overall “alignment tool” - for themselves, their co-founders, early employees, and future employees. Anyone who has experienced an unfair vesting situation will have strong feelings about it - we believe fairness, a balanced approach, and consistency is the key to making vesting provisions work long term in a company.

Term Sheet - Information and Registration Rights

When Jason and I last wrote about term sheets, Jack was still trying to save the world (surprise - he did) and we dealt with a meaty and important issue – vesting. For completeness (and because all good “series” deserve to be finished off), we’re tackling the terms that rarely matter in the next couple of posts. Today we’re starting with *Information Rights* and *Registration Rights*.

You might ask, “If these terms rarely matter, why bother?” Well - you’ll end up having to deal with them in a VC term sheet, so you might as well (a) be exposed to them and (b) hear that they don’t matter much. Of course, from a VC perspective, “doesn’t matter much” means “Mr. Entrepreneur, please don’t pay much attention to these terms - just accept them as is.” Specifically, if one of these terms is being hotly negotiated by an investor or company, that time (and lawyer money) is most likely being wasted.

First up is *Information Rights* – the typical clause follows:

“Information Rights: *So long as an Investor continues to hold shares of Series A Preferred or Common Stock issued upon conversion of the Series A Preferred, the Company shall deliver to the Investor the Company’s annual budget, as well as audited annual and unaudited quarterly financial statements. Furthermore, as soon as reasonably possible, the Company shall furnish a report to each Investor comparing each annual budget to such financial statements. Each Investor shall also be entitled to standard inspection and visitation rights. These provisions shall terminate upon a Qualified IPO.”*

Information rights are generally something companies are stuck with in order to get investment capital. The only variation one sees is putting a threshold on the number of shares held (some finite number vs. “any”) for investors to continue to enjoy these rights.

Registration Rights are more tedious and tend to take up a page or more of the term sheet. The typical clause(s) follows:

“Registration Rights: Demand Rights: *If Investors holding more than 50% of the outstanding shares of Series A Preferred, including Common Stock issued on conversion of Series A Preferred (“Registrable Securities”), or a lesser percentage if the anticipated aggregate offering price to the public is not less than \$5,000,000, request that the Company file a Registration Statement, the Company will use its best efforts to cause such shares to be registered; provided, however, that the Company shall not be obligated to effect any such registration prior to the [third] anniversary of the Closing. The Company shall have the right to delay such registration under certain circumstances for one period not in excess of ninety (90) days in any twelve (12) month period.*

The Company shall not be obligated to effect more than two (2) registrations under these demand right provisions, and shall not be obligated to effect a registration (i) during the one hundred eighty (180) day period commencing with the date of the Company's initial public offering, or (ii) if it delivers notice to the holders of the Registrable Securities within thirty (30) days of any registration request of its intent to file a registration statement for such initial public offering within ninety (90) days.

Company Registration: *The Investors shall be entitled to "piggy-back" registration rights on all registrations of the Company or on any demand registrations of any other investor subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions. If the Investors are so limited, however, no party shall sell shares in such registration other than the Company or the Investor, if any, invoking the demand registration. Unless the registration is with respect to the Company's initial public offering, in no event shall the shares to be sold by the Investors be reduced below 30% of the total amount of securities included in the registration. No shareholder of the Company shall be granted piggyback registration rights which would reduce the number of shares includable by the holders of the Registrable Securities in such registration without the consent of the holders of at least a majority of the Registrable Securities.*

S-3 Rights: *Investors shall be entitled to unlimited demand registrations on Form S-3 (if available to the Company) so long as such registered offerings are not less than \$1,000,000.*

Expenses: *The Company shall bear registration expenses (exclusive of underwriting discounts and commissions) of all such demands, piggy-backs, and S-3 registrations (including the expense of one special counsel of the selling shareholders not to exceed \$25,000).*

Transfer of Rights: *The registration rights may be transferred to (i) any partner, member or retired partner or member or affiliated fund of any holder which is a partnership, (ii)*

any member or former member of any holder which is a limited liability company, (iii) any family member or trust for the benefit of any individual holder, or (iv) any transferee satisfies the criteria to be a Major Investor (as defined below); provided the Company is given written notice thereof.

Lock-Up Provision: Each Investor agrees that it will not sell its shares for a period to be specified by the managing underwriter (but not to exceed 180 days) following the effective date of the Company's initial public offering; provided that all officers, directors, and other 1% shareholders are similarly bound. Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of underwriters shall apply to Major Investors, pro rata, based on the number of shares held.

Other Provisions: Other provisions shall be contained in the Investor Rights Agreement with respect to registration rights as are reasonable, including cross-indemnification, the period of time in which the Registration Statement shall be kept effective, and underwriting arrangements. The Company shall not require the opinion of Investor's counsel before authorizing the transfer of stock or the removal of Rule 144 legends for routine sales under Rule 144 or for distribution to partners or members of Investors."

Registration rights are also something the company will have to offer to investors. What is most interesting about this section is that lawyers seem genetically incapable of leaving this section untouched and always end up "negotiating something." Perhaps because this provision is so long in length, they feel the need to keep their pens warm while reading. We find it humorous (so long as we aren't the ones paying the legal fees), because in the end, the modifications are generally innocuous and besides, if you ever get to the point where registration rights come into play (e.g. an IPO), the investment bankers of the company are going to have a major hand in deciding how the deal is going to be structured, regardless of the contract the company entered into years before when it did an early private financing.

Term Sheet: Right of First Refusal

Today's "term that doesn't matter much" from our term sheet series is the *Right of First Refusal*. When we say "it doesn't matter much", we really mean "don't bother trying to negotiate it away - the VCs will insist on it." Following is the standard language:

“Right of First Refusal: *Investors who purchase at least (____) shares of Series A Preferred (a “Major Investor”) shall have the right in the event the Company proposes to offer equity securities to any person (other than the shares (i) reserved as employee shares described under “Employee Pool” below, (ii) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board; (iii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement or debt financing from a bank or similar financial institution approved by the Board; and (iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their right of first refusal) to purchase [X times] their pro rata portion of such shares. Any securities not subscribed for by an eligible Investor may be reallocated among the other eligible Investors. Such right of first refusal will terminate upon a Qualified IPO. For purposes of this right of first refusal, an Investor’s pro rata right shall be equal to the ratio of (a) the number of shares of common stock (including all shares of common stock issuable or issued upon the conversion of convertible securities and assuming the exercise of all outstanding warrants and options) held by such Investor immediately prior to the issuance of such equity securities to (b) the total number of share of common stock outstanding (including all shares of common stock issuable or issued upon the conversion of convertible securities and assuming the exercise of all outstanding warrants and options) immediately prior to the issuance of such equity securities.”*

There are two things to pay attention to in this term that can be negotiated. First, the share threshold that defines a “Major Investor” can be defined. It's often convenient - especially if you have a large number of small investors - not to have to give this right to them. However, since in future rounds, you are typically interested in getting as much participation as you can, it's not worth struggling with this too much.

A more important thing to look for is to see if there is a multiple on the purchase rights (e.g. the “X times” listed above). This is an excessive ask - especially early in the financing life cycle of a company - and can almost always be negotiated to 1x.

As with “other terms that don’t matter much”, you shouldn’t let your lawyer over engineer these. If you feel the need to negotiate, focus on the share threshold and the multiple on the purchase rights.

Term Sheet: Voting Rights and Employee Pool

Jason and I are feeling the need for closure on our term sheet series as we’ve started gearing up on our next series (M&A). So – we’re going to knock out the balance of the standard term sheet terms this week. We’re still in the “terms that don’t matter much zone” so we’re including *Voting Rights* and *Employee Pool* for completeness.

“Voting Rights: The Series A Preferred will vote together with the Common Stock and not as a separate class except as specifically provided herein or as otherwise required by law. The Common Stock may be increased or decreased by the vote of holders of a majority of the Common Stock and Series A Preferred voting together on an as if converted basis, and without a separate class vote. Each share of Series A Preferred shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such share of Series A Preferred.”

Most of the time voting rights are simply an “FYI” section as all the heavy rights are contained in other sections such as the protective provisions.

“Employee Pool: Prior to the Closing, the Company will reserve shares of its Common Stock so that ___% of its fully diluted capital stock following the issuance of its Series A Preferred is available for future issuances to directors, officers, employees and consultants. The term “Employee Pool” shall include both shares reserved for issuance as stated above, as well as current options outstanding, which aggregate amount is approximately ___% of the Company’s fully diluted capital stock following the issuance of its Series A Preferred.”

The employee pool section is a separate section in order to clarify the capital structure and specifically call out the percentage of the company that will be allocated to the option pool associated with the financing. Since a cap table is almost always included with the term sheet, this section is redundant, but exists so there is no confusion about the size of the option pool.

Term Sheet: Restriction on Sales, Proprietary Inventions, and Co-Sale Agreement

I had good intentions earlier this week to try to crank out the balance of the term sheet series, but it turned into a busy week. Since I'm still muddling through the set of terms that either don't matter much and/or are hard to negotiate away (e.g. chose you battles wisely), I didn't expect anyone would be waiting on the edge of their seats for these. However, for completeness, it's worth going through the stuff that shows up on the last few pages of a standard VC term sheet. Jason and I aren't quite done, but with this post, we are one (tedious) step closer.

Almost every term sheet we've ever seen has a "Restrictions on Sales" clause in it that looks something like:

"Restrictions on Sales: The Company's Bylaws shall contain a right of first refusal on all transfers of Common Stock, subject to normal exceptions. If the Company elects not to exercise its right, the Company shall assign its right to the Investors."

Management / founders rarely argue against this as it helps control the shareholder base of the company which usually benefits all the existing shareholders (except possibly the one who wants to bail out of their private stock.) However, we've found that the lawyers will often spend time arguing how to implement this particular clause. Some lawyers feel that putting this provision in the bylaws is the wrong way to go and prefer to include such a provision in each of the company's option agreements, plans and stock sales. Personally, we find it much easier to include in the bylaws.

Next up is the ubiquitous proprietary information and inventions agreement clause.

“Proprietary Information and Inventions Agreement: Each current and former officer, employee and consultant of the Company shall enter into an acceptable proprietary information and inventions agreement.”

This paragraph benefits both the company and investors and is simply a mechanism that investors use to get the company to legally stand behind the representation that it owns its intellectual property. Many pre-Series A companies have issues surrounding this, especially if the company hasn't had great legal representation prior to its first venture round. We've also run into plenty of situations (including several of ours – oops!) where companies are loose about this between financings and - while a financing is a good time to clean this up – it's often annoying to previously hired employees who are now told “hey – you need to sign this since we need it for the venture financing.” It's even more important in the sale of a company, as the buyer will always insist on clear ownership of the IP. Our best advice here is that companies should build these agreements into their hiring process from the very beginning (with the advice from a good law firm) so that there are never any issues around this, as VCs will always insist on it.

Finally, a co-sale agreement is pretty standard fare as well.

“Co-Sale Agreement: The shares of the Company's securities held by the Founders shall be made subject to a co-sale agreement (with certain reasonable exceptions) with the Investors such that the Founders may not sell, transfer or exchange their stock unless each Investor has an opportunity to participate in the sale on a pro-rata basis. This right of co-sale shall not apply to and shall terminate upon a Qualified IPO.”

If you are a founder, you are probably asking why we did not include the co-sale section in the “really matter section.” The chance of keeping this provision out of a financing is close to zero, so we don't think it's worth the battle to fight it. Notice that this only matters while the company is private – if the company goes public, this clause no longer applies.

Term Sheet: Founders Activities

I'm going to keep tonight's term sheet post short and sweet, especially since I'm still reeling from the horrifyingly bad War of the World movie I just saw. Jason and I are almost done with the term sheet series (yeah, we know we keep promising that) but –

like the Spielberg tragicomedy I just watched, it's not over until it's over (sorry – that cliché just snuck its way in – I was helpless against it – the aliens made me do it.)

Occasionally a term sheet will have – buried near the back - a short clause concerning “founders activities.” It usually looks something like:

“Founders Activities: *Each of the Founders shall devote 100% of his professional time to the Company. Any other professional activities will require the approval of the Board of Directors.”*

This should be no surprise to a founder that your friendly neighborhood VC wants you to be spending 100% (actually 120%) of your time and attention on your company. If this paragraph sneaks its way into the term sheet, the VC has either been recently burned or is suspicious and / or concerned that one or more of the founders may be working on something besides the company in question.

Of course, this is a classic no-win situation for a founder. If you are actually working on something else at the same time and don't disclose it, you are violating the terms of the agreement (and - breaching trust before you get started – not a good thing as it'll eventually come to light.) If you do disclose it – or push back on this clause (hence signaling that you are working on something else), you'll reinforce the concern that the VC has. So – tread carefully here. Our recommendation – unless of course you are working on something else – is simply to agree to this (why wouldn't you, unless you don't believe in the thing you are asking the VC to fund?)

In situations where I've worked with a founder that already has other obligations or commitments, I've always appreciated him being up front with me early in the process. I've usually been able to work these situations out in a way that causes everyone to be happy and – in the cases where I can't get there – I'm glad that the issue came up early so that I didn't waste my time or the entrepreneurs' time.

While there are situations where VCs get comfortable with entrepreneurs working on multiple companies simultaneously (usually with very experienced entrepreneurs or in situations where the VC and the entrepreneur have worked together in the past), they are the exception, not the norm.

Term Sheet: Initial Public Offering Shares Purchase

Jason and I are planning to finish strong with some serious stuff in our term sheet series, but we figured we'd put one more term in that has us sniggling whenever we see it (a "sniggle" is a combination "sneer-giggle" – sort of like how I reacted to Kidman / Ferrell in Bewitched last night). The last sniggle term is as follows:

“Initial Public Offering Shares Purchase: *In the event that the Company shall consummate a Qualified IPO, the Company shall use its best efforts to cause the managing underwriter or underwriters of such IPO to offer to [investors] the right to purchase at least (5%) of any shares issued under a “friends and family” or “directed shares” program in connection with such Qualified IPO. Notwithstanding the foregoing, all action taken pursuant to this Section shall be made in accordance with all federal and state securities laws, including, without limitation, Rule 134 of the Securities Act of 1933, as amended, and all applicable rules and regulations promulgated by the National Association of Securities Dealers, Inc. and other such self-regulating organizations.”*

We firmly put this in the “nice problem to have” category. This term really blossomed in the late 1990's when anything that was VC funded was positioned as a company that would shortly go public. However, most investment bankers will push back on this term if the IPO is going to be a success as they want to get stock into the hands institutional investors (e.g. “their clients”). If the VCs get this push back, they are usually so giddy with joy that the company is going public that they don't argue with the bankers. Ironically, if the VC doesn't get this push back (or even worse, get a call near the end of the IPO road show) where the bankers are asking the VC to buy shares in the offering, the VC usually panics (because it means it's no longer a hot deal) and does whatever he can not to have to buy into the offering.

Sniggle. Our recommendation – don't worry about this one or spend lawyer time on it.

Term Sheet: No Shop Agreement

As an entrepreneur, the way to get the best deal for a round of financing is to have multiple options. If you've been a studious reader of our term sheet series, you are painfully aware that there are many other terms – beside price – that help define what

“the best deal” actually is. However, there comes a point in time where you have to choose your investor and shift from “search for an investor” mode to “close the deal” mode. Part of this involves choosing your lead investor and negotiating the final term sheet with him.

A “no shop agreement” is almost always part of this final term sheet. Think of it as serial monogamy – your new investor to be doesn’t want you running around behind his back just as you are about to get hitched. A typical no shop agreement is as follows:

“No Shop Agreement: *The Company agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, directly or indirectly, (i) take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company, or (ii) enter into any discussions, negotiations or execute any agreement related to any of the foregoing, and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. Should both parties agree that definitive documents shall not be executed pursuant to this term sheet, then the Company shall have no further obligations under this section.”*

At some level the no shop agreement – like serial monogamy – is more of an emotional commitment; it’s very hard to “enforce a no shop agreement” in a financing, but if you get caught cheating, your financing will probably go the same way as the analogous situation when the groom or the bride to be gets caught in a compromising situation.

At some level, the no shop agreement reinforces the handshake that says “ok – let’s get a deal done – no more fooling around looking for a better / different one.” In all cases, the entrepreneur should bound the no shop by a time period – usually 45 to 60 days is plenty (and you can occasionally get a VC to agree to a 30 day no shop.) This makes the commitment bi-directional - you agree not to shop the deal; the VC agrees to get things done within a reasonable time frame.

Term Sheet: Indemnification and Assignment

We're down to our last two sections on a typical VC term sheet. Since they are both things that most entrepreneurs simply live with as part of a financing, we decided to combine them into one post.

The first clause is *indemnification* and usually looks as follows:

“Indemnification: *The bylaws and / or other charter documents of the Company shall limit board member’s liability and exposure to damages to the broadest extent permitted by applicable law. The Company will indemnify board members and will indemnify each Investor for any claims brought against the Investors by any third party (including any other shareholder of the Company) as a result of this financing.”*

Given all the shareholder litigation in recent years, there is almost no chance that a company will get funded without indemnifying its directors. The first sentence is simply a contractual obligation between the company and its board. The second sentence – which is occasionally negotiable – indicates the desire for the company to purchase formal liability insurance. One can usually negotiate away insurance in a Series A deal, but for any follow-on financing, the major practice today is to procure director and officer (D&O) insurance.

The next clause – *assignment* – looks as follows:

“Assignment: *Each of the Investors shall be entitled to transfer all or part of its shares of Series A Preferred purchased by it to one or more affiliated partnerships or funds managed by it or any or their respective directors, officers or partners, provided such transferee agrees in writing to be subject to the terms of the Stock Purchase Agreement and related agreements as if it were a purchaser thereunder.”*

The assignment provision allows venture funds to transfer between funds and make distributions to their limited partners (their investors). This is something companies must normally live with and is a term that is rarely availed upon by investors.

Neither of these terms should be controversial. The company should be willing to indemnify its directors and will likely need to purchase D&O insurance in order to attract outside board members. The assignment clause simply gives VC firms flexibility over transfers which they require to be able to run their business and – as long as the VC is willing to require that any transferee agrees to be subject to the various financing

agreements - the company should be willing to provide for this (although entrepreneurs should be careful not to let the loophole of “assignment without transfer of the obligation under the agreements” occur.)

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