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venture deals

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Chapter 3

Overview of the Term Sheet

At the end of 2005, we participated in a financing that was much more difficult than it needed to be. All of the participants were to blame, and ignorance of what really mattered in the negotiation kept things going much longer than was necessary. We talked about what to do and, at the risk of giving away super-top-secret VC magic tricks, decided to write a blog series on Brad's blog (Feld Thoughts —www.feld.com) that deconstructed a venture capital term sheet and explained each section.

That blog series was the inspiration for this book. The next few chapters cover the most frequently discussed terms in a VC term sheet. Many VCs love to negotiate hard on every term as though the health of their children depended on them getting the terms just right. Sometimes this is inexperience on the part of the VC; often it's just a negotiating tactic.

The specific language that we refer to is from actual term sheets. In addition to describing and explaining the specific terms, we give you examples of what to focus on and implications from the perspectives of the company, VCs, and entrepreneurs.

The Entrepreneur's Perspective

The term sheet is critical. What's in it usually determines the final deal structure. Don't think of it as a letter of intent. Think of it as a blueprint for your future relationship with your investor.

The Key Concepts: Economics and Control

In general, there are only two things that VCs really care about when making investments: economics and control. *Economics* refers to the return the investors will ultimately get in a liquidity event, usually either a sale of the company or an initial public offering (IPO), and the terms that have direct impact on this return. *Control* refers to the mechanisms that allow the investors either to affirmatively exercise control over the business or to veto certain decisions the company can make. If you are negotiating a deal and investors are digging their heels in on a provision that doesn't impact the economics or control, they are often blowing smoke, rather than elucidating substance.

The Entrepreneur's Perspective

Economics and control are important things to pay attention to, in and of themselves. They rule the day. An

inexperienced VC will harp on other terms needlessly. You can give in on them or not, but the mere fact that a VC focuses on unimportant terms is a sign of what that VC will be like to work with as an owner, board member, and compensation committee member.

When companies are created, the founders receive *common stock*. However, when VCs invest in companies, they purchase *equity* and usually receive *preferred stock*. In the following chapters we'll be referring to terms that the preferred shareholders are receiving.

Separate financings are usually referred to as a series designated by a letter, such as *Series A*. The first round is often called the *Series A financing*, although recently a new round occurring before the Series A has appeared called the *Series Seed financing*. The letter is incremented in each subsequent financing, so Series B financings follow Series A, and Series C financings follow Series B. You'll occasionally see a number added onto the letter for subsequent rounds, such as Series A-1 or Series B-2. This is generally done to try to limit how far into the alphabet you go and is often used when the same investors do subsequent rounds in a company together. While we aren't aware of the world record for number of financings in a private company, we have seen a Series K financing.

In each of the following sections, we walk you through language for each term and detailed examples. Let's get started by exploring the economic terms.

Chapter 4

Economic Terms of the Term Sheet

When discussing the economics of a VC deal, one often hears the question "What is the valuation?" While the valuation of a company, determined by multiplying the number of shares outstanding by the price per share, is one component of the deal, it's a mistake to focus only on the valuation when considering the economics of a deal.

In this chapter we discuss all of the terms that make up the economics of the deal, including price, liquidation preference, pay-to-play, vesting, the employee pool, and antidilution.

Price

The first economic term, and the one most entrepreneurs focus on more than any other, is the price of the deal. Following is the typical way price is represented in a term sheet.

> Price: $_____ per share (the Original Purchase Price). The Original Purchase Price represents a fully diluted premoney valuation of $ __ million and a fully diluted postmoney 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 [X] shares prior to this financing.

A somewhat different way that price can be represented is by defining the amount of the financing, which backs into the price. For example:

> Amount of Financing: An aggregate of $X million, representing a __ percent 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 __ percent 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.

While *price per share* is the ultimate measure of what is being paid for the equity being bought, price is often referred to as *valuation*.

There are two different ways to discuss valuation: *premoney* and *postmoney*. The premoney valuation is what the investor is valuing the company at today, before investment, while the postmoney

valuation is simply the premoney valuation plus the contemplated aggregate investment amount. With this, you've encountered the first trap that VCs often lead entrepreneurs into.

When a VC says, "I'll invest $5 million at a valuation of $20 million," the VC usually means the postmoney valuation. In this situation, the VC's expectation is that a $5 million investment will buy 25 percent of a $20 million postmoney company. At the same time, an entrepreneur might hear a $5 million investment at a *premoney* valuation of $20 million, which would buy only 20 percent of the $25 million postmoney company. The words are the same but the expectations are very different.

The term sheet language usually spells this out in detail. However, when you are starting the negotiation with the VC, you'll often have a verbal discussion about price. How you approach this sets the tone for a lot of the balance of the negotiation. By addressing the ambiguity up front, you demonstrate that you have knowledge about the basic terms. The best entrepreneurs we've dealt with are presumptive and say something like "I assume you mean $20 million premoney." This forces the VC to clarify, and if in fact he did mean $20 million premoney, it doesn't cost you anything in the negotiation.

The next part of price to focus on is the phrase *fully diluted*. Both the company and the investor will want to make sure the company has sufficient equity (or *stock options*) reserved to compensate and motivate its workforce. This is also known as the *employee pool* or *option pool*. The bigger the pool the better, right? Not so fast. Although a large option pool will make it less likely that the company will run out of available options, the size of the pool is taken into account in the valuation of the company, thereby effectively lowering the actual premoney valuation. This is common valuation trap number two.

Let's stay with our previous example of a $5 million investment at $20 million premoney. Assume that you have an existing option pool that has options representing 10 percent of the outstanding stock reserved and unissued. The VCs suggest that they want to see a 20 percent option pool. In this case, the extra 10 percent will come out of the premoney valuation, resulting in an effective premoney valuation of $18 million.

There is no magic number for the option pool, and this is often a key point of the pricing negotiation. The typical option pool ends up in a range of 10 percent to 20 percent, but if the investors believe that the option pool of the company should be increased, they will insist that the increase happens prior to the financing.

You have several negotiating approaches. You can fight the pool size, trying to get the VCs to end up at 15 percent instead of 20 percent. Or you can negotiate on the premoney valuation; accept a 20 percent pool but ask for a $22 million premoney valuation. Or you can suggest that the increase in the option pool gets added to the deal postmoney, which will result in the same premoney valuation but a higher postmoney one.

The Entrepreneur's Perspective

VCs will want to minimize their risk of future dilution as much as possible by making the option pool as large as possible up front. When you have this negotiation, you should come armed with an *option budget*. List out all of the hires you plan on making between today and your next anticipated financing date and the approximate option grant you think it will take to land each one of them. You should be prepared to have an option pool with more options than your budget calls for, but not necessarily by a huge margin. The option budget will be critical in this conversation with your potential investor.

Another economic term that you will encounter, especially in later stage financings, is *warrants* associated with financings. As with the stock option pool allocation, this is another way for an investor to sneak in a lower valuation for the company. A warrant is similar to a stock option; it is a right for an investor to purchase a certain number of shares at a predefined price for a certain number of years. For example, a 10-year warrant for 100,000 shares of Series A stock at $1 per share gives the warrant holder the option to buy 100,000 shares of Series A stock at $1 per share anytime in the next decade, regardless of what the stock is worth at the moment in time the investor avails himself of (or *exercises*) the warrant.

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 premoney 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 even though it impacts the future allocation of proceeds in a liquidity event.

There is one type of financing—the *bridge loan*—in which warrants are commonplace. A bridge loan occurs when an investor is planning to do a financing, but is waiting for additional investors to participate. In the bridge loan scenario the existing investor will make the investment as *convertible debt*, which will convert into equity at the price of the upcoming financing. Since the bridge loan investor took additional risk, he generally gets either a discount on the price of the equity (usually up to 20 percent) or warrants that effectively grant a discount (again usually up to 20 percent, although occasionally more). In bridge round cases, it's not worth fighting these warrants as long as they are structured reasonably.

The best way for you to negotiate a higher price is to have multiple VCs interested in investing in your company. This is 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 dilution of the existing investors. If there are no new investors interested in investing in

your company, your existing investors will often argue for a price equal to (*flat round*) or lower than (*down round*) the price of 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 for 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, since they can materially help or hurt this process.

The Entrepreneur's Perspective

The best Plan A has a great Plan B standing behind it. The more potential investors you have interested in investing in your company, the better your negotiating position is. Spend as much time on your *best alternative to a negotiated agreement* (BATNA) as possible.

By now you may be wondering how VCs really value companies. It is not an exact science regardless of the number of spreadsheets involved. VCs typically take into account many factors when deciding how to value a potential investment—some are quantifiable whereas others are completely qualitative. Following are some of the different factors, along with brief explanations of what impacts them.

- *Stage of the company.* Early stage companies tend to have a valuation range that is determined more by the experience of the entrepreneurs, the amount of money being raised, and the perception of the overall opportunity. As companies mature, the historical financial performance and future financial projects start to have impact. In later stage companies, supply and demand for financing combined with financial performance dominate, as investors are beginning to look toward an imminent exit event.

- *Competition with other funding sources.* The simple time-tested rule for the entrepreneur is "more is better." When VCs feel like they are competing with other VCs for a deal, price tends to increase. However, a word of caution—don't overplay competition that doesn't exist. If you do and get caught, you'll damage your current negotiating position, potentially lose the existing investor that you have at the table, and, if nothing else, lose all of your leverage in other aspects of the negotiation. Our belief is that you should always negotiate honestly. Overrepresenting your situation rarely ends well.

- *Experience of the entrepreneurs and leadership team.* The more experienced the entrepreneurs, the less risk, and, correspondingly, the higher the valuation.

- *The VC's natural entry point.* Some VCs are early stage investors and will invest only at low price points. For example, we know of one well-known early stage investor who

publicly states the intention not to invest at a valuation above $10 million postmoney. Later stage investors tend to be much less focused on a specific price level and are more focused on the specific status of the company. While VC firms often have stated strategies, it's often the case that they will diverge from these strategies, especially when markets heat up.

- *Numbers, numbers, numbers.* The numbers matter also. Whether it is past performance; predictions of the future; revenue; earnings before interest, taxes, depreciation, and amortization (EBITDA); cash burn; or head count, they each factor into the determination of price. That being said, don't believe everything your MBA professor told you about DCF (discounted cash flow, for those of you without an MBA), especially for early stage companies. Remember, the only thing you know for sure about your financial projections at the early stages is that they are wrong.

- *Current economic climate.* Though this is out of the control of the entrepreneur, it weighs heavily on pricing. When the macroeconomy is in the dumps, valuations are lower. When the macroeconomy is expanding, valuations go up. Specifically, valuations often expand quickly when there is future optimism forecasted about the macroeconomy. However, these events are not tightly correlated, especially in the technology sector.

Our best advice to entrepreneurs on maximizing price is to focus on what you can control and get several different VCs interested in your financing.

The Entrepreneur's Perspective

I encourage entrepreneurs not to take valuation personally. Just because VCs say their take is that your business is worth $6 million, when your take is that your business is worth $10 million, doesn't mean that they lack appreciation for you as a CEO or your business's future potential. It means they are negotiating a deal to their advantage, just as you would.

Liquidation Preference

The liquidation preference is the next most important economic term after price and impacts how the proceeds are shared in a liquidity event, which is usually defined as a sale of the company or the majority of the company's assets. The liquidation preference is especially important in cases in which a company is sold for less than the amount of capital invested.

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 pertain only 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] times the Original Purchase Price plus any declared but unpaid dividends (the Liquidation Preference).

This is the actual preference. In this language, 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 1× liquidation preference, or simply the amount of money invested, was the standard. In 2001, as the Internet bubble burst, investors often increased this multiple, sometimes as high as 10× (10 times the amount of money invested). Over time, rational thought prevailed and this number has generally returned to 1×.

The next thing to consider is whether the investors' shares are participating. While many people consider the term *liquidation preference* to refer to both the preference and the participation, it's important to separate the concepts. There are three varieties of participation: full participation, capped participation, and no participation.

Fully participating stock will receive its participation amount and then share in the liquidation proceeds on an *as-converted basis* where "as-converted" means as if the stock were converted into common stock based on its conversion ratio. 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 an as-converted basis until a certain multiple return is reached. Sample language is as follows.

> 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 this 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 percent of its original purchase price was returned, including any amounts paid out on the liquidation preference. This is not an additional 3× return, but rather an additional 2×, assuming the liquidation preference was a 1×

money-back return. Perhaps this correlation with the actual preference is the reason 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 preceding ones.

Since we've been talking about liquidation preferences, it's important to define what a *liquidation event* is. Often, entrepreneurs think of a liquidation event as a bad thing, such as a bankruptcy or a winding down. In VC-speak, a liquidation is actually tied to a *liquidity event* in which the shareholders receive proceeds for their equity in a company, and it includes mergers, *acquisitions*, or a change of control of the company. As a result, the liquidation preference section determines the allocation of proceeds in both good times and bad. Standard language defining a liquidation event 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 a liquidation event. Jason once had an entertaining and unpleasant debate during a guest lecture he gave at his alma mater law school with a partner from a major Chicago law firm. At the time, this partner was teaching a venture class that semester and claimed that an IPO 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 (there's not a 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. In fact, in almost all 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.

Let's explore several different cases. To keep it simple, let's assume that there has been only one round of financing (a Series A investment) of $5 million at a $10 million premoney valuation. In this case, the Series A investors own 33.3 percent of the company [$5m/($10m + $5m)] and the entrepreneurs own 66.7 percent of the company. To make the math a little easier, we'll round it to 33 percent/67 percent.

Now, assume that the company has an offer to be acquired for $30 million.

> Case 1: 1× preference, nonparticipating: In this case, the Series A investors will get 33 percent, or $10 million, and the entrepreneurs will get 67 percent, or $20 million.
>
> Case 2: 1× preference, participating: In this case, the Series A investors will get the first $5 million and then 33 percent of the remaining amount, or $8.3 million (33 percent of $25 million) for a total return of $13.3 million. The entrepreneurs will get 67 percent of the $25 million, or $16.7 million.

Case 3: 1× preference, participating with a 3× cap: In this case, the preferred will not reach the cap ($15 million), so this will be the same as Case 2.

Now, assume the purchase price is $100 million and there has still been only one Series A financing of $5 million at a $15 million postmoney valuation.

Case 1: 1× preference, nonparticipating: The Series A investors will get 33 percent, or $33 million, and the entrepreneurs will get 67 percent, or $67 million.

Case 2: 1× preference, participating: Again, the Series A investors get the first $5 million and then 33 percent of the remaining $95 million, or $31.35, for a total of $36.35. The entrepreneurs get 67 percent of the remaining $95 million, or $63.65 million.

Case 3: 1× preference, participating with a 3× cap: In this example, the Series A makes a return better than 3×, so the participation doesn't happen and the results are the same as in Case 1.

As you can see from this example, the participation feature has a lot of impact at relatively low outcomes and less impact (on a percentage of the deal basis) at higher outcomes. The participation feature will also matter a lot more as more money is raised that has the participation feature (e.g., Series B and C). To understand this, let's do one last example, this time of a company that has raised $50 million where the investors own 60 percent and the entrepreneurs own 40 percent. Assume the company is being acquired for $100 million.

Case 1: 1× preference, nonparticipating: Investors get 60 percent, or $60 million, and the entrepreneurs get 40 percent, or $40 million.

Case 2: 1× preference, participating: Investors get the first $50 million, and then 60 percent of the remaining $50 million ($30 million) for a total of $80 million. The entrepreneurs get 40 percent of the remaining $50 million, or $20 million.

Case 3: 1× preference, participating with a 3× cap: Since the investors won't make greater than 3× on this deal, this is the same as Case 1.

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, since understanding how liquidation preferences work between the various 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 (known as *stacked preferences*) where Series B gets its preference first, then Series A.

2. The series are equivalent in status (known as *pari passu* or *blended preferences*) so that Series A and B share proratably until the preferences are returned.

Determining which approach to use is a black art that 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 current phase of the moon.

Let's look at an example. This time, our example company has raised two rounds of financing, a Series A ($5 million invested at a $10 million premoney valuation) and a Series B ($20 million invested at a $30 million premoney valuation). Now, let's deal with a low outcome, one where the liquidation preference is going to come into play, namely a sale of the company for $15 million.

If the preference is stacked, the Series B investors will get the entire $15 million. In fact, in this case it won't matter what the premoney valuation of the Series B was; they'll get 100 percent of the consideration regardless.

However, if the preference is blended, the Series A will get 20 percent of every dollar returned (in this case $3 million) and the Series B will get 80 percent of every dollar returned (or $12 million), based on their relative amounts of the capital invested in the company.

In each of these cases the entrepreneurs will receive nothing regardless of whether the preference is participating or nonparticipating since the preference is $25 million and the company is being sold for $15 million, or less than the preference.

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. Realize, however, that in the fully participating case the investors get their participation amount and then receive what they would get on a fully converted common holding basis.

In early stage financings, it's actually in the best interest of both the investor and the entrepreneur to have a simple liquidation preference and no participation. In future rounds, the terms are often at the minimum equivalent to the early stage terms. So, if you have a participating preferred in a seed round, you could expect to have a participating preferred in all subsequent rounds. In this case, if the seed investor doesn't participate in future rounds, his economics in many outcomes could actually be worse with the participation feature. As a result, we recommend to entrepreneurs and our VC co-investors to keep it simple and lightweight in early rounds.

Most professional investors will not want to gouge a company with excessive liquidation preferences since the greater the liquidation preference, the lower the potential value of the management or 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 ensuring 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.

The Entrepreneur's Perspective

Liquidation preference is a critical term that is part of most equity financings other than small angel financings. Participating preferred deals have become an unfortunate standard over the years where VCs have essentially decided on a new standard floor for deals that require the repayment of principal as well as a common stock interest in the company on the sale of a company. In the mid-1990s, companies used to negotiate so-called kick-outs whereby participation rights went away as long as the company had achieved a meaningful return for the VC (2× to 3×). Entrepreneurs should band together to reinstate this as a standard!

Anything other than a straight participating preferred security, such as multiple preferences, is just greedy on the part of VCs and should be a red flag to you about the investor.

Pay-to-Play

The *pay-to-play* provision is another important economic term that is usually relevant in a down round financing and can be very useful to the entrepreneur in situations where the company is struggling and needs another financing. A typical pay-to-play provision 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.
>
> 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.

At the turn of the millennium, a pay-to-play provision was rarely seen. After the Internet bubble burst in 2001, it became ubiquitous. Interestingly, 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, investors must keep participating proratably in future financings (paying) in order to not have their preferred stock converted to common stock (playing) in the company.

There are various levels of intensity of the pay-to-play provision. The preceding one is pretty aggressive when compared to this softer one:

> 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.
>
> 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 that are not current stockholders of the Company.

We believe that pay-to-play provisions are generally good for the company and its investors. It causes the investors to stand up at the time of their original investment and agree to support the company during its life cycle. 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 ensures that all the investors agree in advance to the rules of engagement concerning future financings.

The pay-to-play provision impacts the economics of the deal by reducing liquidation preferences for the nonparticipating investors. It also impacts the control of the deal since it reshuffles the future preferred shareholder base by ensuring that only the committed investors continue to have preferred stock and the corresponding rights that go along with preferred stock.

When companies are doing well, the pay-to-play provision is often waived since 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.

The Entrepreneur's Perspective

This pay-to-play provision is pretty good for you as an entrepreneur, at least as it's described here. Conversion to common is no big deal in the grand scheme of things. What you want to avoid is a pay-to-play scenario where your VC has the right to force a recapitalization of the company (e.g., a financing at a $0 premoney valuation, or something suitably low) if fellow investors don't play into a new round.

A provision like this can be particularly bad for less sophisticated angel investors (e.g., your friends and family) if they don't have the understanding or resources to back up their initial investment with future follow-on investments, and can make for uncomfortable conversations around family events.

There are many circumstances where reasonable investors who like the company can't or won't participate in a financing—their venture fund is over, or they are strategic or angel investors and don't have the funds or charter to continue investing—and you and they shouldn't be punished excessively for not participating (remember, a recapitalization hurts you, too, even if you get new options, which always carry vesting, to "top you off"). But conversion to common for lack of follow-on investment is appropriate.

Vesting

Although vesting is a simple concept, it can have profound and unexpected implications. Typically, stock and options will vest over four years. This means that you have to be around for four years to own all of your stock or options (from this point forward, we'll simply refer to the equity that the entrepreneurs and employees receive as stock, although exactly the same logic applies to options). If you leave the company before the end of the four-year period, the vesting formula applies and you get only 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 percent to vest at the end of the first year following such issuance, with the remaining 75 percent 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 vesting thereafter for a total of four years. This means that if you leave before the first year is up, you haven't vested any of your stock. After a year, you have vested 25 percent (that's the "cliff"). Then you begin vesting monthly (or quarterly, or annually) over the remaining period. If you have a monthly vest with a one-year cliff and you leave the company after 18 months, you'll have vested 37.5 percent (or 18/48) of your stock.

Often, founders will get somewhat different vesting provisions than the rest of the employees. A common term is the second paragraph of the example clause, where the founders receive one year of vesting credit at the closing of the financing 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. In cases where the founders started the company within a year of the first VC investment, they will occasionally be able to argue for vesting back to the inception of the company.

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, stockholders, and option holders) all benefit ratably from the increase in ownership, also known as *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.

In some cases, founders own their stock outright through a purchase at the time that the company is established. While the description of what happens to this founders' stock is often referred to as vesting, it's actually a buy-back right of the company. Though there are technically the same outcomes, the legal language around this is somewhat different and matters for tax purposes.

The Entrepreneur's Perspective

How a founder's stock vests is important. Although simple vesting can work, you should consider alternative strategies such as allowing you to purchase your unvested stock at the same price as the financing if you leave the company, protecting your position for a termination "without cause," or treating your vesting as a *clawback* with an Internal Revenue Code Section 83(b) election so you can lock in long-term capital gains tax rates early on (which is discussed later in this book).

A key component of vesting is defining what, if anything, happens to vesting schedules upon a merger. *Single-trigger acceleration* refers to automatic accelerated vesting upon a merger. *Double-trigger acceleration* refers to two events needing to take place before accelerated vesting, specifically an acquisition of the company combined with the employee in question being fired by the acquiring company.

In VC-funded deals, a double trigger is much more common than a 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 acquirers will want there to be some forward-looking incentive for founders, management, and employees, so they usually prefer some unvested equity to exist to help motivate folks to stick around for a period of time postacquisition. In the absence of this, the acquirer will include a separate management retention incentive as part of the deal value. Since this management retention piece is included in the value of the transaction, it effectively reduces the consideration that gets allocated to the equity owners of the company, including the VCs and any founders who are no longer actively involved in the company. This often frustrates VCs since it puts them at cross-purposes with management in an acquisition 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 here:

> 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 1990s when pooling of interests was an accepted form of accounting treatment, since there were significant constraints on any modifications to vesting agreements. Pooling was abolished in early 2000 and, under current acquisition accounting treatment (also known as 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 such as a double trigger with one-year acceleration and recognize that this will often be negotiated during an acquisition. It's important to recognize that many VCs have a distinct point of view on this; some VCs will never do a deal with single-trigger acceleration, whereas some VCs don't really care very much. As in any negotiation, make sure you are not negotiating against a point of principle, as VCs will often say, "That's how it is and we won't do anything different."

Recognize that vesting works for the founders as well as the VCs. We have been involved in a number of situations where one founder didn't stay with the company very long either by choice or because the other founders wanted him to leave the company. In these situations, if there hadn't been vesting provisions, the person who didn't stay at the company would have walked away with all of his

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 founder's moral imperative. The same rule applies to employees; since equity is another form of compensation, vesting is the mechanism to ensure the equity is earned over time.

Time to exit has a huge impact on the relevancy of vesting. In the late 1990s, 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. In a market where the typical gestation period of an early stage company is five to seven years, most people, especially founders and early employees who 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; a balanced approach and consistency are key to making vesting provisions work long-term in a company.

The Entrepreneur's Perspective

While single-trigger acceleration might seem appealing, double-trigger acceleration with some boundaries makes a lot of sense. Any entrepreneur who has been on the buy side of an acquisition will tell you that having one or two years' worth of guaranteed transition on the part of an acquired management team is critical to an acquisition's financial success.

Employee Pool

Another economic term that matters, but is often not focused on until the end of the negotiation, is the *employee pool* (also known as the *option pool*). The employee pool is the amount of the company that is reserved for future issuance to employees. Typical language follows:

> Employee Pool: Prior to the Closing, the Company will reserve shares of its Common Stock so that __ percent 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 __ percent of the Company's fully diluted capital stock following the issuance of its Series A Preferred.

The employee pool is called out as a separate section in order to clarify the capital structure and specifically define the percentage of the company that will be allocated to the option pool associated with the financing. Since a *capitalization 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.

It is important to understand the impact of the size of the pool on the valuation of the financing. As with premoney and postmoney valuations, VCs often sneak in additional economics for themselves by increasing the amount of the option pool on a premoney basis.

Let's go through an example. Assume that a $2 million financing is being done at a $10 million postmoney valuation. In this case, the new investors get 20 percent of the company for $2 million and the effective postmoney valuation is $10 million. Before the financing there is a 10 percent unallocated option pool. However, in the term sheet, the investors put a provision that the postfinancing unallocated option pool will be 20 percent. This results in a postfinancing ownership split of 20 percent to the new investors, 60 percent to the old shareholders, and an unallocated employee pool of 20 percent.

In contrast, if the 10 percent option pool that previously existed was simply rolled over, the postmoney allocation would still be 20 percent to new investors, but the old shareholders would get 70 percent and the unallocated option pool would be 10 percent.

While in both cases the investors end up with 20 percent, the old investors have 10 percent less ownership in the case of the 20 percent option pool. Although the additional ownership will ultimately end up in the hands of future employees, it is effectively coming out of the old shareholders rather than being shared between the new investors and the old shareholders. This will result in a lower price per share for the new investors and effectively a lower premoney valuation.

If the VC is pushing for a larger option pool to come out of the premoney valuation but the entrepreneur feels that there is enough in the pool to meet the company's needs over the time frame of this financing, the entrepreneur can say, “Look, I strongly believe we have enough options to cover our needs. Let's go with it at my proposed level and if we should need to expand the option pool before the next financing, we will provide full antidilution protection for you to cover that.”

Antidilution

The final key economic provision is *antidilution*. A typical antidilution clause in a term sheet follows:

> Antidilution 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 antidilution 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.

Yeah, we agree—that's a mouthful. It's also a clause that often trips up entrepreneurs. While the antidilution provision is used to protect investors in the event a company issues equity at a lower valuation than in previous financing rounds, it is also an excuse for lawyers to use a spreadsheet. There are two varieties: *weighted average antidilution* and *ratchet-based antidilution*.

Full ratchet antidilution means that if the company issues shares at a price lower than the price for the series with the full ratchet provision, then the earlier round 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 less harsh but rarely seen.

Full ratchets came into vogue in the 2001–2003 time frame when down rounds were all the rage, but the most common antidilution 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 previous round, all of the previous round stock would be repriced to the new issuance price. In a weighted average world, the number of shares issued at the reduced price is considered in the repricing of the previous round. 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 as follows:

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)

Note that despite the fact one is buying preferred stock, the calculations are always done on an as-if-converted (to common stock) basis. The company is not issuing more shares; rather, it determines a new conversion price for the previous series of stock. Alternatively, the company can issue more shares, but we think this is a silly and unnecessarily complicated approach that merely increases the amount the lawyers can bill the company for the financing. Consequently, antidilution provisions usually generate a *conversion price adjustment*.

You might note the term *broad-based* in describing weighted average antidilution. What makes the provision broad-based versus narrow-based is the definition of common stock outstanding (CSO). A broad-based weighted average provision encompasses 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 that 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 will 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, as you'll often find different lawyers arguing over what to include or not include in the definitions.

In our example language, we've included a section that is generally referred to as "antidilution *carve-outs*"—the section "other than shares (i) … (iv)." These are the standard exceptions for shares granted at lower prices for which antidilution does not apply. 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 antidilution 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 antidilution provision. Having the larger investors (the majority of the class) step up and vote to carve the financing out of the antidilution terms was a bonus for the company common stockholders and employees, who would have suffered the dilution of additional antidilution 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, antidilution 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 antidilution provisions hurt Series A investors more than later investors if you assume the Series A price is the low-water mark 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 benefits from the antidilution provision at the expense of the Series A. Our experience is that antidilution is usually requested despite this, as Series B investors will most likely always ask for it and, since they do, the Series A investors proactively ask for it anyway.

In addition to economic impacts, antidilution provisions can have control impacts. First, the existence

of an antidilution provision will motivate the company to issue new rounds of stock at higher valuations because of the impact of antidilution protection on the common stockholders. In some cases, a company may pass on taking an additional investment at a lower valuation, although practically speaking, this happens only when a company has other alternatives to the financing. A recent phenomenon is to tie antidilution 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 antidilution adjustment occurs automatically if the company does not meet its objectives, unless the investor waives it 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 predetermined product and sales milestones set at the time of a financing is not always best for the long-term development of a company, especially if these goals end up creating a diverging set of objectives between management and the investors as the business evolves.

Antidilution provisions are almost always part of a financing, so understanding the nuances and knowing which aspects to negotiate are an important part of the entrepreneur's tool kit. We advise you not to get hung up in trying to eliminate antidilution provisions. Instead, focus on minimizing their impact and building value in your company after the financing so they don't ever come into play.

Chapter 5

Control Terms of the Term Sheet

The terms we discussed in the preceding chapter define the economics of a deal; the next batch of terms define the control parameters of a deal. VCs care about control provisions in order to keep an eye on their investment as well as comply with certain federal tax statutes that are a result of the types of investors that invest in VC funds. While VCs often have less than 50 percent ownership of a company, they usually have a variety of control terms that effectively give them control of many activities of the company.

In this chapter we discuss the following terms: board of directors, protective provisions, drag-along rights, and conversion.

Board of Directors

One of the key control mechanisms is the process for electing the board of directors. The entrepreneur should think carefully about what the proper balance should be among investor, company, founder, and outside representation on the board.

The Entrepreneur's Perspective

Electing a board of directors is an important, and delicate, point. Your board is your inner sanctum, your strategic planning department, and your judge, jury, and executioner all at once. Some VCs are terrible board members, even if they're good investors and nice people.

A typical board of directors clause follows:

> Board of Directors: The size of the Company's Board of Directors shall be set at [X]. 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 or common stockholders, and one by mutual consent), you should consider what is best: chosen by mutual consent of the board (one person, one vote) or 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 who works with them on their companies.

The Entrepreneur's Perspective

Be wary of observers. Sometimes they add no value yet they do take up seats at the table. Often, it's not about who votes at a board meeting, but the discussion that occurs, so observers can sway the balance of a board. You don't want to find yourself with a pre-revenue company and 15 people around the table at a board meeting.

Many investors will mandate that one of the board members chosen by common stockholders 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.

Let's go through two examples: an early stage board for a company that has raised its first round of capital and the board of a company that is mature and contemplating an initial public offering (IPO).

In the case of the early stage board, there will typically be five board members:

1. Founder
2. CEO
3. VC
4. A second VC
5. An outside board member

This would be the default case for a balanced board that gives the VC enough influence to be comfortable without having control over the board. Correspondingly, the founder and CEO will have the same number of seats as the VCs, and the outside board member will be able to help resolve any conflicts that arise as well as be a legitimately nonconflicted board member.

In the case of a mature board, you'll typically see more board members (seven to nine) with more

outside board members. The CEO and one of the founders are on this board along with a few of the VCs (depending on the amount of money raised). However, the majority of the additions to the board are outside board members, typically experienced entrepreneurs or executives in the domain in which the company is operating.

While it is appropriate for board members 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.

Protective Provisions

The next key control term you will encounter in the term sheet is the *protective provisions*. Protective provisions are effectively veto rights that investors have on certain actions by the company. Not surprisingly, these provisions protect VCs, although unfortunately not from themselves.

The protective provisions are often hotly negotiated but over time have mostly become standardized. Entrepreneurs would like to see few or no protective provisions in their documents. In contrast, VCs would like to have some veto-level control over a set of actions the company could take, especially when it impacts the VCs' 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; (viii) results in the payment or declaration of any dividend on any shares of Common or Preferred Stock; or (ix) results in issuance of debt in excess of $100,000.

Let's translate this into what the VC is trying to protect against. Simply, unless the VC agrees, don't:

- Change the terms of stock owned by the VC.
- Authorize the creation of more stock.
- Issue stock senior or equal to the VC's.
- Buy back any common stock.
- Sell the company.
- Change the certificate of incorporation or bylaws.
- Change the size of board of directors.
- Pay or declare a dividend.
- Borrow money.

Subsection (ix) of the protective provision clause 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 start-up. 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—through either a positive or a negative event.

Many company counsels will ask for *materiality qualifiers*—for instance, that the word *material* or *materially* be inserted in front of subsections (i), (ii), and (vi) in the example. We always decline this request, not to be stubborn, but because we don't really know what *material* means (if you ask a judge or read any case law, that will not help you, either), and we believe that specificity is more important that debating reasonableness. Remember that these are protective provisions; they don't eliminate the ability to do these things, but 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 have a debate over what the word *material* means in the middle of a situation where these protective provisions might come into play.

The Entrepreneur's Perspective

As far as the example protective provision clause is concerned, (i) fair is fair; (ii) fair is fair; (iii) fair is fair; (iv) this should be positive for VCs, but not a big deal; (v) this is critical as long as Series A preferred holders represent, in aggregate, enough of your capitalization table to be relevant; (vi) makes sense; (vii) this is critical as long as Series A preferred holders represent, in aggregate, enough of your cap table to be relevant; (viii) you will never have to worry about this; (ix) this is fine, though you should try to get a higher limit or an exclusion for equipment financing in the normal course of business.

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 class. There are two cases: the Series B gets its own protective provisions or 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, 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 Series B investors are the same as Series A investors, this is an irrelevant discussion and it should be easy for everyone to default to voting as a single class. If you have new investors in the Series B, be wary of inappropriate veto rights for small investors; for example, the consent percentage required is 90 percent instead of a majority (50.1 percent), enabling a new investor who owns only 10.1 percent of the financing to effectively assert control over the protective provisions through his vote.

The Entrepreneur's Perspective

Regardless of who your investors are, fight to have them vote as a single class. It's critical for your sanity. It keeps investors aligned. And as long as your capitalization table is rational, it won't matter.

Some investors feel they have enough control with their board involvement to ensure that 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 shortsighted approach for the investor, since, 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 when 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 those of a shareholder, shining a brighter light on an area of potential conflict.

While one could make the argument that protective provisions are at the core of the trust between a VC and an entrepreneur, we think that's a hollow and naive 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, and the protective provisions cut to the heart of this.

Occasionally the protective provisions can help the entrepreneur, especially in an acquisition scenario. Since the investor can effectively block a sale of the company, this provides the entrepreneur with some addition leverage when negotiating with the buyer since the price needs to be high enough to garner the VC's consent on the deal. Of course, this assumes a reasonable position from the existing investor, but in most cases an experienced VC will support the entrepreneur's decision to sell a company.

A decade ago the protective provisions took several days to negotiate. Over time these provisions have been hotly tested in courts of law from several important judicial decisions, so today they have become mostly boilerplate.

The Entrepreneur's Perspective

Remember, you are negotiating this deal on behalf of the company (no matter who runs it in the future) and with the investors (no matter who owns the shares in the future). These terms are not only about your current relationship with the VC in question.

Drag-Along Agreement

Another important control provision is the *drag-along agreement*. Typical language 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.

The drag-along agreement gives a subset of the investors the ability to force, or drag along, all of the other investors and the founders to do a sale of the company, regardless of how the folks being dragged along feel about the deal.

After the Internet bubble burst and sales of companies started occurring that were at or below the

liquidation preferences, entrepreneurs and founders—not surprisingly—started to resist selling the company in these situations since they often weren't getting anything in the deal. While there are several mechanisms to address sharing consideration below the liquidation preferences, such as the notion of a *carve-out*, which we'll discuss later, 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, whereas others are stubborn in their view that since they lost money, management and founders shouldn't receive anything.

In each of these situations, the VCs would much rather control their ability to compel other shareholders to support the transaction. 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 stock waived part of their liquidation preferences in favor of the common stock. Needless to say, this particular holdout technique did not go over well in the venture community and, as a result, the drag-along agreement became more prevalent.

If you are faced with a drag-along situation, your ownership position will determine whether or not this is an important issue for you. An acquisition 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). However, most acquirers will want 85 percent to 90 percent of shareholders to consent to a transaction. If you own 1 percent of a company and the VCs would like you to sign up to a drag-along agreement, it doesn't matter that much unless there are 30 of you who each own 1 percent. Make sure you know what you are fighting for in the negotiation, and don't put disproportionate energy against terms that don't matter.

When a company is faced with a drag-along agreement in a VC financing proposal, the most common compromise position is to try to get the drag-along rights to pertain to following the majority of the common stock, not the preferred. This way, if you own common stock, you are dragged along only when a majority of the common stockholders 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 we've always been willing to take when we've owned common stock in a company (e.g., “I'm not going to stand in the way of something a majority of folks who have rights equal to me want to do”). Of course, preferred investors can always convert some of their holdings to common stock to generate a majority, but this also results in a benefit to the common stockholders as it lowers the overall liquidation preference.

The Entrepreneur's Perspective

This is one of those terms that matter most if things are falling apart, in which case you probably have bigger fish to fry. And it cuts both ways—if you have a lot of investors, for example, this term can force them all to agree to a deal, which might save you from a lot of agitation down the road. Of course, it is best to not be in a fire sale

situation, or at least to have enough board members whom you control (at least effectively, if not contractually) so that you can prevent a bad deal from happening in the first place.

Conversion

While many VCs posture during term sheet negotiations by saying things like "That is nonnegotiable," terms rarely are. Occasionally, though, a term will actually be nonnegotiable, and conversion is one such term.

The Entrepreneur's Perspective

Amen. "This is nonnegotiable" is usually a phrase thrown out by junior members of VC firms when they don't know any better. In particular, watch out for the "This is how we always do deals" or "This is a standard deal term for us" negotiating tactic as being ultra-lame and a sign that the people you're negotiating with don't really know what they are doing.

In all the VC deals we've ever seen, the preferred shareholders have the right—at any time—to convert their stake into common stock. 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 buyers of preferred to convert to common should they determine on a liquidation that they would be better off getting paid on an as-converted common basis rather than accepting the liquidation preference and the participation 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. Note, however, that once converted, there is no provision for reconverting 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 almost always want to see everyone convert into common stock at the time of the IPO. It is rare for a venture-backed company to go public with multiple classes of stock, although occasionally you will see dual classes of shares in an IPO as Google had. The thresholds for the automatic conversion are critical to negotiate. As the entrepreneur you want them lower to ensure more flexibility, whereas your investors will want them higher to give them more control over the timing and terms of an IPO.

Regardless of the actual thresholds, it's important 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 with one class of preferred stockholders having a threshold above what the proposed offering would result in; as a result, these stockholders have an effective veto right on the offering.

For example, assume that you have an early stage investor with an automatic conversion threshold of $30 million and a later stage investor with an automatic conversion threshold of $60 million. Now, assume you are at the goal line for an IPO and it's turning out to be a $50 million offering based on the market and the demand for your company. Your early investor is ready to go, but your later stage investor suddenly says, "I'd like a little something else since I can block the deal and even though you've done all of this work to get to an IPO, I don't think I can support it unless. …" In these cases, much last-minute legal and financial wrangling ensues given the lack of alignment between your different classes of investors. To avoid this, we strongly recommend that you equalize the automatic conversion threshold among all series of stock at each financing.

The Entrepreneur's Perspective

Understand what the norms are for new IPOs before you dig your heels in on conversion terms. There's no reason to negotiate away other more critical terms over a $20 million threshold versus a $30 million threshold if the norm is $50 million. Besides, a board decision to pursue an IPO will put pressure on a VC to waive this provision.

Chapter 6

Other Terms of the Term Sheet

Up to this point we've been exploring terms that matter a lot and fall under the category of economics or control. As we get further into the term sheet, we start to encounter some terms that don't matter as much, are only impactful in a downside scenario, or don't matter at all.

This chapter covers those terms, which include dividends, redemption rights, conditions precedent to financing, information rights, registration rights, right of first refusal, voting rights, restriction on sales, proprietary information and inventions agreement, co-sale agreement, founders' activities, initial public offering shares purchase, no-shop agreement, indemnification, and assignment.

Dividends

Whereas private equity guys love dividends, many venture capitalists, especially early stage ones, don't really care about them. In our experience, the VCs who do care about dividends either come from a private equity background or are focused on downside protection in larger deals.

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 percent] 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 additional juice in a deal. Let's do some simple math. Assume a typical dividend of 10 percent (dividends will range from 5 to 15 percent depending on how aggressive your investor is; we picked 10 percent to make the math easy).

Now, assume that the VC has negotiated hard and gotten a 10 percent cumulative annual dividend. In this case, the VC automatically gets the dividend every year. To keep the math simple, let's assume the dividend does not compound. As a result, each year the VC gets 10 percent of the investment as a dividend. Assume a home run deal such as a 50× return on a $10 million investment in five years. Even with a 10 percent cumulative annual dividend, this increases the VC's return from $500 million to only

$505 million (the annual dividend is $1 million, or 10 percent of $10 million, times five years).

While the extra money from the dividend is nice, it doesn't really move the needle in the success case. Since venture funds typically have a 10-year life, the dividend generates another 1× return only if you invest on day one of a fund and hold the investment for 10 years.

This also assumes the company can actually pay out the dividend. Usually the dividends can be paid in either stock or cash, typically 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 in which it is important not to get head-faked by the investor, where the dividend becomes another form of antidilution protection—one that is automatic and simply linked to the passage of time.

We are being optimistic about the return scenarios. In downside cases, the dividend can matter, especially as the invested capital increases. For example, take a $40 million investment with a 10 percent annual cumulative dividend in a company that was sold at the end of the fifth year to another company for $80 million. In this case, assume that there was a simple liquidation preference with no participation and the investor got 40 percent of the company for his investment (at a $100 million postmoney valuation). Since the sale price was below the investment postmoney valuation (i.e., a loser, but not a disaster), the investor will exercise the liquidation preference and take the $40 million plus the dividend ($4 million per year for five years, or $20 million). In this case, the difference between the return in a no-dividend scenario ($40 million) and a dividend scenario ($60 million) 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 $50 million) and the expectation for return multiples on invested capital is lower.

Automatic dividends have some nasty side effects, especially if the company runs into trouble, since they typically should be included in the solvency analysis. If you aren't paying attention, an automatic cumulative dividend can put you unknowingly into the *zone of insolvency*, which is a bad place to be. Cumulative dividends can also be an accounting nightmare, especially when they are optionally paid 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 noncumulative dividend when declared by the board 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.

The Entrepreneur's Perspective

The thing to care about here is ensuring that dividends have to be approved by a majority—or even a supermajority

—of your board of directors.

Redemption Rights

Even though redemption rights rarely come into play, many VCs are often overly focused on them in the deal because they provide additional downside protection. A typical redemption rights clause follows:

> Redemption at Option of Investors: At the election of the holders of at least a 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 VC's part) that a company will become successful enough to be an ongoing 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, a company that is around for a while as a going concern while not being an attractive initial public offering (IPO) or acquisition candidate generally won't have the cash to pay out redemption rights.

Another reason for redemption rights pertains to the life span of venture funds. The average venture fund has a 10-year life span to conduct its business. If a VC makes an investment in year five of the fund, it might be important for that fund manager to secure redemption rights in order to have a liquidity path before the 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. By optics, we mean how certain third-parties view the health and stability of the company such as bankers, customers and employees. 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 that we view as overreaching—the *adverse change redemption*. We recommend you never agree to the following term that has recently crept into term sheets:

> Adverse Change Redemption: Should the Company experience a material adverse change to its prospects, business, or financial position, the holders of at least a 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 term effectively gives the VC a right to a redemption in the case of a "material adverse change to its … business." The problem is that "material adverse change" is not defined, is a vague concept, is too punitive, and shifts an inappropriate amount of control to the investors based on an arbitrary judgment of the investors. If this term is being proposed and you are getting resistance on eliminating it, make sure you are speaking to a professional investor and not a loan shark.

In our experience, redemption rights are well understood by VCs and should not create a problem, except in a theoretical argument between lawyers and accountants.

The Entrepreneur's Perspective

> I don't worry about redemption rights much, although the adverse change redemption clause is evil. As with dividends, just make sure you have maximum protection around your board, or all classes of preferred shareholders voting in aggregate, and not just the majority of a random class of shareholder declaring these.

Conditions Precedent to Financing

While there is a lot to negotiate, a term sheet is simply a step on the way to an actual deal. Term sheets are often nonbinding (or mostly nonbinding) and most VCs 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 seem pretty innocuous, but they occasionally have additional ways out of a deal for the investor that the entrepreneur should watch for, if only to better understand the current mind-set of the investor proposing the investment.

A typical conditions precedent to financing clause looks like this:

> 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 a detailed budget for the following twelve (12) months, acceptable to Investors.

Note that the investors will try to make a few things binding—specifically that legal fees get paid

whether or not a deal happens, the company can't shop the deal once the term sheet is signed, or the governing law be set to a specific domicile—while explicitly stating that a bunch things still have to happen before this deal is done, and they can back out for any reason.

The Entrepreneur's Perspective

Try to avoid conditions precedent to financing as much as possible. Again, the best Plan A has the strongest Plan B standing behind it. Your prospective VC should be willing to move quickly and snap up your deal on acceptable terms by the time the VC gets to a term sheet. At a minimum, do not agree to pay for the VC's legal fees unless the deal is completed (with a possible carve-out for you canceling the deal).

There are three conditions to watch out for since they usually signal something nonobvious on the part of the VC. They are:

1. *Approval by investors' partnerships.* This is 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 VCs want to offer all previous investors in the company the ability to participate in the currently contemplated financing. This is not necessarily a bad thing, as in most cases it serves to protect all parties from liability, but it does add time and expense to the deal.

3. *Employment agreements signed by founders as acceptable to investors.* Be aware of 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. You'll want to try to do this before you sign a term sheet and accept a no-shop clause, but most VCs will wave you off and say, "Don't worry about it—we'll come up with something that works for everyone." Make sure you understand the key terms such as compensation and what happens if you get fired.

The Entrepreneur's Perspective

Insist on spelling out key terms prior to a signed term sheet if it has a no-shop clause in it. A VC who won't spell out key employment terms at the beginning is a big red flag.

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

Information Rights

We are back to another ubiquitous term that is important to the VC but shouldn't matter much to the entrepreneur. Information rights define the type of information the VC legally has access to and the time frame in which the company is required to deliver it to the VC.

> Information Rights: So long as an Investor continues to hold [any] 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.

You might ask, "If these terms rarely matter, why bother?" Since you will end up having to deal with them in a VC term sheet, you might as well be exposed to them and hear that they don't matter much. Of course, from a VC perspective, "doesn't matter much" can also mean "Mr. Entrepreneur, please don't pay much attention to these terms—just accept them as is." However, our view is that if an investor or the company is hotly negotiating this particular term, that time (and lawyer money) is most likely being wasted.

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 versus "any") for investors to continue to enjoy these rights.

The Entrepreneur's Perspective

> If you care about information rights for your shareholders, you are nuts. You should run a transparent organization as much as possible in the twenty-first century. If you can't commit to sending your shareholders a budget and financial statements, you shouldn't take on outside investors. If you are of the paranoid mind-set (which I generally applaud), feel free to insist on a strict confidentiality clause to accompany your information rights.

Registration Rights

Registration rights define the rights that investors have to registering their shares in an IPO scenario as well as the obligation of the company to the VCs whenever they file additional registration statements after the IPO. This is a tedious example of something that rarely matters, yet tends to take up a page or more of the term sheet. Get ready for your mind to be numbed.

> Registration Rights: Demand Rights: If Investors holding more than 50 percent 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 "piggyback" 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 percent 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, piggybacks, 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 who satisfies the criteria to be a Major Investor (as defined below); provided the Company is given written notice thereof.

Lockup 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 percent shareholders are similarly bound. Such lockup 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 something the company will almost always have to offer to investors. What is most interesting about registration rights is that lawyers seem genetically incapable of leaving this section untouched and always end up negotiating something. Perhaps because this provision is so long, they feel the need to keep their pens warm while reading. We find it humorous (as 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 stage financing.

The Entrepreneur's Perspective

Don't focus much energy on registration rights. This is more about upside. The world is good if you're going public.

Right of First Refusal

The right of first refusal defines the rights that an investor has to buy shares in a future financing. Right of first refusal is another chewy term that takes up a lot of space in the term sheet but is hard for the entrepreneur to have much impact on. Following is the typical 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.

The right of first refusal is also known as a *pro rata right*. While almost all VCs will insist on a right of first refusal, 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 from your existing investors 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). This is often referred to as a *super pro rata right* and is an excessive ask, especially early in the financing life cycle of a company.

The Entrepreneur's Perspective

> The right of first refusal is not a big deal, and in some cases it's good for you. But make sure you define what a major investor is and give this only to them. At a minimum, you can make sure that shareholders get this right only if they play in subsequent rounds.

Voting Rights

Voting rights define how the preferred stock and the common stock relate to each other in the context of a share vote. It is another term that doesn't matter that much. The typical language follows:

> 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 time the voting rights clause is simply an FYI section, as all the important rights, such as the protective provisions, are contained in other sections.

Restriction on Sales

The restriction on sales clause, also known as the right of first refusal on sales of common stock (or ROFR on common) defines the parameters associated with selling shares of stock when the company is a private company. Typical language follows:

> 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.

Historically, founders and management rarely argue against this, as it helps control the shareholder base of the company, which usually benefits all the existing shareholders (except possibly the ones who want to bail out of their private stock). However, we've found that the lawyers will often spend time arguing about how to implement this particular clause—specifically whether to include it in the bylaws or include it in each of the company's option agreements, plans, and stock sales. We find it easier to include this clause in the bylaws since then it's in one place and is hard to overlook.

In the early days of venture capital (say, until 2007) there was a strong conventional wisdom that founders and management shouldn't be able to sell their shares until the investors could sell their shares, through either an IPO or a sale of the company. As the time to liquidity for private companies stretched out and IPOs became less common, this philosophy shifted. Simultaneously, a healthy secondary market for founders and early employee shares appeared, fueled both by the rapid rise in valuation of private companies such as Facebook and Twitter, along with the emergence of private secondary markets such as Second Market and SharesPost. The result is a lot more sales of private stock to other investors (sometimes new ones, sometimes the existing investors) along with much more scrutiny and discussion around the ROFR on common construct.

After being involved in several situations where this has come into play, we feel more strongly than ever that an ROFR on common is a good thing for the company and should be supported by the founders, management, and investors. Controlling the share ownership in a private company is important, especially as the Securities and Exchange Commission (SEC) takes a closer look at various private shareholder rules—both regarding ownership and for stock sales. The ROFR on common gives the company the ability to at least know what is going on and make decisions in the context of the various proposals.

Proprietary Information and Inventions Agreement

Every term sheet we've ever seen has a 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 (IP). 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!) in which 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 this agreement.

The Entrepreneur's Perspective

A proprietary information and inventions agreement clause is good for the company. You should have all employees, including founders, sign something like this before you do an outside venture financing. If someone on the team needs a specific carve-out for work in progress that is unrelated to the business, you and your investors should be willing to grant it.

Co-Sale Agreement

Most investors will insist on a co-sale agreement, which states that if a founder sells shares, the investors will have an opportunity to sell a proportional amount of their stock as well. Typical language follows:

> 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.

The chance of keeping this provision out of a financing is close to zero, so we don't think it's worth fighting it. Notice that this matters only while the company is private—if the company goes public, this clause no longer applies.

The Entrepreneur's Perspective

Your chances of eliminating the co-sale agreement clause may be zero, but there's no reason not to ask for a floor to it. If you or your co-founders want to sell a small amount of stock to buy a house, why should a VC hold it up? A right of first refusal on the purchase with a bona fide outside offer's valuation as the purchase price is one thing. An

effective exclusion is something entirely different.

Founders' Activities

As you wind your way through a typical term sheet, you'll often see, buried near the back, a short clause concerning founders' activities. It usually looks something like this:

> Founders' Activities: Each of the Founders shall devote 100 percent of his professional time to the Company. Any other professional activities will require the approval of the Board of Directors.

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

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 in addition to breaching trust before you get started. If you do disclose other activities 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.

In situations where we've worked with a founder who already has other obligations or commitments, we've always appreciated him being up front with us early in the process. We've usually been able to work through these situations in a way that results in everyone being happy and, in the cases where we couldn't get there, were glad that the issue came up early so that we didn't waste our time or the entrepreneur's 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.

The Entrepreneur's Perspective

If you can't agree to a founders' activities clause, don't look for professional VC financing. Or you can negotiate a very specific carve-out, and expect other consequences in your terms (e.g., vesting and IP rights).

Initial Public Offering Shares Purchase

One of the terms that falls into the "nice problem to have" category is the initial public offering shares purchase.

> 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 percent] 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.

This term blossomed in the late 1990s 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 of institutional investors (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 they don't get this push-back, or even worse, get a call near the end of the IPO road show in which the bankers are asking them to buy shares in the offering, they usually panic and do whatever they can to not have to buy into the offering since this means the deal is no longer a hot one.

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

No-Shop Agreement

As an entrepreneur, the way to get the best deal for a round of financing is to have multiple options. However, there comes a point in time when 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 follows:

> No-Shop Agreement: The Company agrees to work in good faith expeditiously toward 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 or 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 regard 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 than a legal one. While it's very hard, but not impossible, to enforce a no-shop agreement in a financing, 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.

The no-shop agreement reinforces the handshake that says, "Okay, let's get a deal done—no more fooling around looking for a better or different one." In all cases, the entrepreneur should bound the no-shop agreement by a time period—usually 45 to 60 days is plenty, although you can occasionally get a VC to agree to a 30-day no-shop agreement. This makes the commitment bidirectional—you agree not to shop the deal; the VC agrees to get things done within a reasonable time frame.

Now, some entrepreneurs still view that as a unilateral agreement; namely, the entrepreneur is agreeing to the no-shop but the VC isn't really agreeing to anything at all. In most cases, we don't view the no-shop clause as terribly important since it can be bounded with time. Instead, we feel it's much more important for the entrepreneur to test the VCs commitment to follow through on the investment when signing up to do the deal.

Specifically, in some cases VCs put down term sheets early, well before they've got internal agreement within their partnership to do an investment. This used to be more common; today many early stage VCs don't want to go through the hassle of drafting the term sheet and trying to negotiate it unless they believe they will do the deal. In addition, there is a potential negative reputational impact for the VC, as word will get around that VC X puts term sheets out early, but then can't or won't close. In the age of the Internet, this type of reputation spreads like an infectious disease.

Although we've done hundreds of investments, we came up with only a few examples in the past 15 years where the no-shop agreement had any meaningful impact on a deal in which we were involved. When we thought about the situations in which we were the VC and were negatively impacted by not having a no-shop agreement (e.g., a company we had agreed with on a term sheet went and did something else) or where we were on the receiving end of a no-shop agreement and were negatively impacted by it (e.g., an acquirer tied us up but then ultimately didn't close on the deal), we actually didn't feel particularly bad about any of the situations since there were both logic associated with the outcome and grace exhibited by the participants. Following are two examples:

We signed a term sheet to invest in Company X. We didn't include a no-shop clause in the term sheet. We were working to close the investment (we were 15 days into a 30-ish-day process) and had legal documents going back and forth. One of the founders called us and said that they had just received an offer to be acquired and they wanted to pursue it. We told them no problem—we'd still be there to do the deal if it didn't come together. We were very open with them about the pros and cons of doing the deal from our perspective and, given the economics, encouraged them to pursue the acquisition offer (it was a great deal for them). They ended up closing the deal and, as a token, gave us a small amount of equity in the company for our efforts (totally unexpected and unnecessary, but appreciated).

In another situation we were already investors in a company that was in the process of closing an outside-led round at a significant step-up in valuation. The company was under a no-shop agreement with the new VC. A week prior to closing, we received an acquisition overture from one of the strategic investors in the company. We immediately told the new lead investor about it, who graciously agreed to suspend the no-shop agreement and wait to see whether we wanted to move forward with the acquisition or with the financing. We negotiated with the acquirer for several weeks, checking regularly with the new potential investor to make sure they were still interested in closing the round if we chose not to pursue the acquisition. They were incredibly supportive and patient. The company covered its legal fees up to that point (unprompted—although it was probably in the term sheet that we'd cover them; we can't recall). We ended up moving forward with the acquisition; the new investor was disappointed in the outcome but happy and supportive of what we did.

While both of these are edge cases, in almost all of our experiences the no-shop agreement ended up being irrelevant. As each of these examples shows, the quality and the character of the people involved made all the difference and were much more important than the legal term.

The Entrepreneur's Perspective

As an entrepreneur, you should also ask that the no-shop clause expire immediately if the VC terminates the process. Also, consider asking for a carve-out for acquisitions. Frequently financings and acquisitions follow each other around. Even if you're not looking to be acquired, you don't want handcuffs on conversations about an acquisition just because a VC is negotiating with you about a financing.

Indemnification

The indemnification clause states that the company will indemnify investors and board members to the maximum extent possible by law. It is another one that entrepreneurs just have to live with. It follows:

> Indemnification: The bylaws and/or other charter documents of the Company shall limit board members' 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 directors' and officers' (D&O) insurance. We believe companies should be willing to indemnify their directors and will likely need to purchase D&O insurance in order to attract outside board members.

The Entrepreneur's Perspective

> You should have reasonable and customary directors' and officers' (D&O) insurance for yourself as much as for your VCs. While the indemnification clause is good corporate hygiene, make sure you follow it up with an appropriate insurance policy.

Assignment

We end this chapter with the assignment clause, another clause in a typical term sheet that isn't worth spending legal time and money negotiating.

> 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 clause simply gives VC firms flexibility over transfers that they require to be able to run their business and, as long as the VC is willing to require that any transferee agree to be subject to the various financing agreements, the company should be willing to provide for this. However, watch out for one thing—don't let the loophole "assignment without transfer of the obligation under the agreements" occur. You need to make sure that anyone who is on the receiving end of a transfer abides by the same rules and conditions that the original purchasers of the stock signed up for.