Venture Capital

What should be included in a Term Sheet or letter of intent for a venture capital investment?

Once a venture capital firm determines that it wishes to invest in a particular business or company, it will draft a Term Sheet or letter of intent and present it to the potential portfolio company. The main purposes of the Term Sheet are to set out the material terms upon which the venture capital firm will invest, to lock up the potential target for investment for a reasonable period of exclusivity in order to enable the venture capital firm to complete its business and legal due diligence, and to providing ample time to finalize the definitive documents and to close the transaction.

What are the common elements of a Term Sheet?

Term Sheets commonly include the following elements:

A. The preamble sets out the parties to the transaction and makes it clear that the Term Sheet is not the definitive agreement, but rather a mere outline of the material terms.

B. A brief summary of the transaction is often included that sets out the economic terms of the investment.

C. The Term Sheet will also set forth the percentage ownership of the prospective shareholders upon completion of the investment.

D. The company will usually wish to lock in a hard closing date to occur as soon as possible. On the other hand, the venture capital firm often views the closing date as a “soft” target and would prefer to have as much time as it can obtain to complete its legal and business due diligence. As a consequence, this provision is frequently amended during the due diligence phase as long as both parties are comfortable that each are working in good faith toward a closing.

E. The venture capital firm prefers a clear description of the use of the proceeds and will sometimes tie it into a pre-approved business plan. In contrast, the company will prefer as much flexibility as possible and often seeks to use broad language such as “for working capital purposes.”

F. The venture capital firm will generally want to incentivize the management team and employees with equity based stock options. The key issues for negotiation include the size of the option pool and who gets to participate. For example, the pool may focus on a range of 15% to 22% with the senior management team owning 8% to 10%. However, this percentage of ownership and sharing varies from industry to industry.

G. The venture capital firm will often require representations and warranties to be provided by the individual founders. The founders, on the other hand, will only want the company to provide the representations and warranties.

H. The investors will typically receive preferred stock that has a dividend component. The preferred stock can be viewed as a different security than the common stock thereby providing another reason for the common stock options to be granted to employees at a discount to the purchase price for the preferred stock. The dividend component also adds an extra rate of return for the investors. Dividends may be cumulative or non-cumulative. Dividends may also accrue automatically or only if declared by the board of directors. Venture capital firms prefer cumulative dividends while the company prefers non-cumulative dividends paid only if declared by the board of directors. Dividends may also be paid in kind (a “PIK”).

I. The venture capital firm will typically want a liquidation preference to be paid not only upon a liquidation event, but also at their option upon a sale or merger or a public offering of the company. Venture capital firms also want to receive accrued dividends upon a liquidation. “Non-participating” preferred typically receives an amount equal to the initial investment plus accrued and unpaid dividends upon a liquidation event. Holders of common stock then receive the remaining assets. “Participating” preferred also typically receives an amount equal to the initial investment plus accrued and unpaid dividends upon a liquidation event. However, participating preferred then participates on an “as converted to common stock” basis with the common stock in the distribution of the remaining assets.

J. Generally, preferred stock is converted on a 1 for 1 basis into common stock. However, the conversion ratio is usually subject to adjustment if preferred shares are issued at a lower price or if there is a structural change to the capitalization of the company, such as a stock split. In the case of a public offering, the underwriter will almost always require the preferred stock to be converted to common stock in connection with the offering.

K. The holders of the preferred stock may desire special voting rights as a class on certain matters. In rare instances, where the founder is a recognized and irreplaceable asset of the business, he or she too may want to obtain special voting rights. Typically, however, the holders of the preferred stock will vote on an as-if-converted basis with the common stockholders, except with respect to certain protective provisions.

L. The investors will typically request the right to require the company to register its shares for sale. Registration rights will include both “demand” and “piggyback” rights.

M. The Term Sheet will include provisions ensuring that the investors receive current and accurate reporting of financial and other critical metrics relating to the company.

N. The investors will want pre-emptive rights giving them the right to invest additional capital in future financings so that they can maintain their ownership position and prevent dilution.

O. An investor will typically request flexibility to transfer the investment to an affiliated entity.

P. The composition of the board of directors is a common subject of negotiation. Many venture capital firms prefer a smaller board of directors for early stage companies so that a manageable core group of professionals can move quickly to make decisions. The venture capital firm may also require that the investors as a group have control of the board. Arguably, it is in the interest of all parties involved that one or more independent directors be installed on the board, particularly as the company anticipates a potential liquidity event. Many corporate governance experts recommend an odd number of directors to void the potential for a deadlock.

Q. Most venture capital firms will insist on including certain protective provisions requiring the vote of a specified percentage of the holders of the preferred shares before the company can engage in certain specified transactions, e.g., a merger, reorganization, sale of control, modification of the preferences or privileges of the preferred stock, a material change in the company's business plan, a change in the company's auditor, an expansion of the number of directors, etc.

R. A venture capital firm will typically insist upon directors and officers insurance and sometimes "key man" insurance for one or more key senior executives.

S. A venture capital firm will usually request a right of first refusal to acquire the shares of other major shareholders and the right to "drag-along" all major shareholders in the event of a sale.

T. The venture capital firm does not want to expend the time and money to complete its due diligence unless it is certain that the company is not using its offer to start a bidding process with other potential investors. Accordingly, the venture capital firm will request a standstill agreement prohibiting any of the stockholders, directors, officers, employees, agents or representatives from directly or indirectly soliciting inquiries or engaging in discussions with third parties concerning the sale of the assets or any of the capital stock of the company.

U. The Term Sheet will usually include confidentiality and public non-disclosure provisions, as well as provisions for the company to pay the expenses of the transaction, including the legal fees of the venture capital firm, subject to a cap, if the transaction closes.

What is participating preferred?

The basic liquidation preference, i.e., when the investors are entitled to receive either their liquidation preference or to convert their preferred shares into common stock, was created to provide downside protection for the investors. Under a participating preference, the investors receive their preference, or some multiple of their preference, and their interest as a common stockholder on an as-converted basis. As a compromise between the basic liquidation preference and a participating liquidation preference, the parties may agree to a participating preference but with a cap. In this situation, the investors can receive their liquidation preference and their pro rata interest as a common holder, but only up to a certain stated amount.

When are warrants used?

When the investors and the company are unable to reach a mutually acceptable agreement as to the valuation of the company one way to bridge the gap is for the company to issue warrants to the investors. Often the exercise price of the warrants is at a discount to the price paid for the preferred stock, so the investors are able to average the price paid for the securities and to justify the valuation of the enterprise. However, some investors negotiate the purchase warrants where the exercise price is greater than the price paid for the preferred stock. The rationale is that if the company is hugely successful, then the investors are able to lock in a warrant price now that will allow them to participate in more of the company's up side, and thus increase their rate of return, without affecting the valuation of the company today. The company will sometimes issue warrants to a strategic investor to induce the strategic investor to commit to a contract or transaction that will add value to the company. In this case, the warrants are typically exercisable only upon the accomplishment of certain strategic goals.

What is a mandatory redemption?

A mandatory redemption is a way for investors to force the company into an exit by a specific point in time so that the investors can obtain a reasonable rate of return on their investment. Companies clearly prefer not to include mandatory redemption provisions, since it may force the company to sell or refinance at an inopportune time.

What is venture debt?

When people think of venture capital, they typically think of rounds of equity financing utilizing the sale of preferred stock. However, venture capital firms also purchase debt as a means of financing a company. A venture capital firm that is already an investor in the company will be the most likely source for a debt financing. A venture capital firm might look to purchase debt instead of simply acquiring additional preferred stock if there are no available sources for equity financing at an agreeable valuation, the company needs money very quickly and it does not have the time to explore equity alternatives, the company needs money as a bridge financing to get over a hurdle so that its next financing is at a stepped-up valuation or to provide the time necessary to effect an equity financing that may be in process, to finance the acquisition of assets, or to provide growth capital if the business has enough projected cash flow to support the debt.

What is involved with due diligence?

As soon as the Term Sheet is finalized, the venture capital firm typically sends the company an extensive due diligence checklist intended to enable the venture capital firm to make an informed investment decision and prepare for negotiations by identifying potential risks or problems of the company and to confirm that the value and purchase price per share determined during the Term Sheet negotiation actually reflects the appropriate value for the company. Due Diligence typically covers such matters as the following:

- Corporate records
- Stock and securities issuances
- Material agreements
- Related party transactions
- Intellectual property assets
- Confidentiality and related agreements
- Employment matters
- Financial statements and tax documentation
- Litigation
- Industry and business of the company

What is the most important document in the venture capital financing transaction?

Arguably, the most important document in a venture capital financing transaction is the company's Articles of Incorporation, a/k/a Certificate of Incorporation or "Charter." While the stock purchase agreement defines the specific terms upon which the particular venture capital investment will be made, and other documents, such as the stockholders' agreement and registration rights agreement, contain key terms regarding preemptive rights, transfer restrictions, registration of securities, reporting of information relative to the corporation and other important items, the Articles of Incorporation are ultimately the document that establishes and defines the nature and substantive provisions of the securities purchased, which is typically preferred stock. The Articles of Incorporation also define most of the key economic and non-economic rights, preferences and privileges of the preferred stock, as well as the common stock. Thus, almost all preferred stock financings involve an amendment to the company's Articles of Incorporation.

What are anti-dilution provisions?

Investments in venture capital transactions are typically made in the form of one or more securities which, by their terms, are convertible into, exercisable for, or exchangeable for, shares of common stock. This gives rise to the need for adjustments to the conversion terms to protect the rights of the holder in the event of structural changes involving the capitalization of the company or the issuance of securities at prices lower than the issue price of the original security.

Convertible preferred stock enables a venture capital investor to acquire a hybrid security that is structured to provide a minimum preferred return on the investment in the event of a merger or sale, liquidation or similar event, while at the same time providing a means to convert to common stock and thereby realize the uncapped equity return that a common stockholder would receive. Preferred “participating” stock enables the holder to receive an initial liquidation preference, generally equal to the initial purchase price paid (or some multiple of the price), usually with accrued and unpaid dividends, followed by a right to participate on an “as converted to common basis” in any additional proceeds available for distribution.

Convertible notes are sometimes used for early stage financings of companies, often in “seed financings,” prior to a more formal funding by one or more venture capital firms. The investment is typically structured as the purchase of a note which by its terms is convertible, either at the option of the holder or at the election of the company, into equity securities in conjunction with the next round of equity financing of a minimum size at the issue price of the financing or at a discount to that price. These notes do not establish a current value for the company, but defer that determination to a subsequent equity financing. The conversion feature provides a mechanism for investors to provide funds to the company at an early stage without agreeing upon a current value for the company, and for those funds to be converted into equity at the time a more formal financing establishes a value for the equity.

Warrants are often used as additional consideration for the equity investment. The warrants may be exercisable for the same form of equity securities issued initially to the venture capital firm, for “next round securities,” or for the underlying common stock of the company. Warrants are typically issued for a nominal or specified consideration and at a specified exercise price or an exercise price that relates to the issue price of the underlying security. The exercise price for the number of shares issued upon conversion are subject to adjustment for structural changes to the capitalization of the company and to reflect dilutive financings.

They also include provisions to participate in dividends or other distributions that would otherwise reduce the underlying equity value of the warrants.

What is covered in the purchase agreement?

The purchase agreement is the basic agreement setting forth the terms pursuant to which the venture capital investors agree to purchase, and the company agrees to sell and/or issue, equity securities at a specified price. Beyond these basic terms, most of the negotiations regarding the purchase agreement tend to focus on the company's representations and warranties. The purchase agreement typically will not cover the rights, privileges and preferences of the equity securities being sold. These rights, privileges and preferences typically will be covered in the company's organizational documents. Similarly, the purchase agreement will not cover certain common agreements among the shareholders, such as tag-along or drag-along rights, or among the shareholders and the company, such as registration rights, which are typically addressed in separate agreements.

What is an investor rights agreement?

Many investor protections are provided in the Articles of Incorporation, e.g., liquidation preferences, anti-dilution protection, voting rights, and redemption provisions. However, there are a number of important protective provisions meaningful to investors that are not covered in the Articles of Incorporation and these are typically set forth in an Investor Rights Agreement ("IRA"). The IRA covers such matters are registration rights, pre-emptive rights in future financings, information and observer rights, and other protective covenants.

What strategies are utilized by venture capital firms to control their risk?

Generally speaking, venture capital firms face financing risk, operational risk and exit risk. For example, to control financing risk, a venture capital firm may control the amount of invested capital by using tranched financing. In a tranched financing, a venture capital firm will split a single financing round into one or more stages. After the initial stage, the investor will only provide additional capital to the company if the company meets certain agreed upon prerequisite objectives or milestones. Venture capital firms mitigate risk associated with the operation of a company by negotiating for a seat on the company's board of directors and by obtaining certain protective voting rights. Finally, they control liquidity options, i.e., their exit risk, by negotiating terms that force the liquidation of the securities they hold or prevent others from compelling a liquidation event to occur. These terms include registration rights, first refusal/co-sale rights, drag-along rights and redemption rights.

What are rights of first refusal and co-sale agreements?

As a condition to investing in a company, a venture capital firm will typically require the company's founders to enter into agreements aligning the interests of the founders with the interests of the investors by, among other things, preventing the founders from "cashing out" their equity positions in advance of the financial investors. These agreements also typically enable the venture investors to require that the other shareholders sell their shares in the company when the venture capitalists determine that it is an optimal time to sell the business. These arrangements may be included in a stockholders' agreement, a right of first refusal and co-sale agreement or, if the company is a limited liability company, in the limited liability company's operating agreement.

What agreements are typically entered into with the founder?

Venture investors typically require certain restrictions and protections to be imposed on the founder both to protect the company and in anticipation of requirements from future investors. These arrangements may include full-blown employment agreements incorporating non-competition provisions, vesting (or reverse vesting) of equity or options, intellectual property assignment provisions, and confidentiality and non-solicitation of employee provisions. Because the founder's ownership in the company may be diluted significantly by the new investment, the founders also desire to have certain protections and clarity surrounding their relationship going forward.

What exit strategies are used by venture capital firms?

The most common liquidity events for start-up companies involve a sale or merger of the company to or with another company. Shareholders, including venture capitalists, may sell their stock privately to other accredited or qualified investors, and even the liquidating or winding down a company may serve as an exit strategy, but these types of liquidity events are the exception rather than the rule. An initial public offering is also an exit strategy. In fact, the "JOBS Act" signed into law on April 5, 2012, contains various provisions that make going public more attractive for companies that qualify as “emerging growth companies” (“EGCs”). However, liquidity exits are nonetheless most frequently effectuated by a sale or merger of the company.

What issues arise in connection with down round financings?

One of the problems facing venture capital investors is how to finance a portfolio company when the company’s valuation is currently lower than its valuation at the time of the last financing round. If the company proceeds with a “down round financing” at a lower valuation, it will reduce the economic and voting power of the current shareholders who choose not to participate. In those circumstances, the venturing investors, who typically have representatives on the company’s board of directors, need to be careful with the procedures they set up for the new financing round in order to mitigate the likelihood that the board will be sued for a breach of its fiduciary duties.

What is a “pay-to-play” provision?

A pay-to-play provision is a method by which investors in a proposed financing round can incentivize current stockholders to participate by either rewarding participation or penalizing a failure to participate. For example, an investor that declines to participate in a proposed financing on a pro rata basis may have all of its preferred stock converted into common stock or a shadow preferred stock, known as “shadow series” or “shadow preferred.” In both cases, the investor loses rights such as liquidation preferences, anti-dilution protection, protective provisions, dividends, participation rights in future financings, and voting rights relating to specific company actions. This is sometimes referred to as a “strong man” pay-to-play provision. In contrast, a “pull-up” or “pull-through” pay-to-play provision is where an investor who decides to participate in the proposed financing is rewarded by receiving additional rights, such as having its junior preferred stock converted into the current senior preferred with enhanced rights or receiving board representation.

What is a management carve-out?

A management incentive plan, also known as a management carve-out or retention plan, is typically used to motivate management and key employees to favor a sale of the company and ensure that they continue to operate the business through the sale process and, if the acquirer desires, thereafter.

What issues are associated with founders' equity?

When forming a new business enterprise, the standard stock structure that features a single class of common stock generally does not provide adequate flexibility for the founders to protect their ability to control the board of directors or sell their shares efficiently. There is also a growing trend for founders to seek some liquidity at the time of a major financing prior to a sale or going public as opposed to waiting for a company exit event. One solution is to create two classes of common stock, e.g. "Class E" (for entrepreneur), which is issued to the founders, and "Class A," which is issued to employees and which underlies the company's option pool. The company can then grant to its founders shares of Class E common stock which can subsequently be sold or redeemed without adversely affecting the price at which the company grants options which convert into Class A common stock. Outside investors in early stage companies generally seek certain control provisions themselves to protect their investment. The amount of control relinquished by the founders will ultimately be the product in negotiation, but entrepreneurs can improve their starting position by staking their claim to certain company controls in the Articles of Incorporation. For example, the Class E common stock may be issued with rights and preferences similar to those provided by some types of preferred stock. However, in providing founders with control using rights and preferences in the Class E common stock, the founders need to consider how those features will appear to outside investors.