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## Deciphering Term Sheets

An entrepreneur's first dose of "reality" about the venture capital community often comes when a potential investor generates and delivers a term sheet for a proposed investment. Until that point, platitudes typically abound as the investor talks glowingly and enthusiastically about how much he or she believes in the startup. The entrepreneur's excitement grows as he or she thinks about the great partner that will be coming into the fold. But the term sheet is where the rubber hits the road and serious business negotiations begin.

For someone who has not been through the process, the term sheet can seem overbearing and confusing, and an entrepreneur's initial reaction might be, "but I thought we were all friends." Term sheets serve several useful purposes, however, the most important of which is that they help to efficiently and effectively nail down the major negotiating points. This means that documenting and closing the deal – with a detailed agreement – will move faster, which not only allows the company to get its capital sooner, but also limits the legal costs of the company. This is especially significant when an entrepreneur is dealing with an institutional venture capitalist who will require the company to pay not only the legal fees of the company's counsel but also the legal fees of the VC's counsel.

Term sheets differ depending upon the type of investment being made (debt or equity). An equity term sheet typically summarizes the purchase of a type of equity interest in the company (e.g., capital stock, membership interests/units) with preferential rights (i.e., "preferred" stock). Although attention must be given to the preferential rights, the valuation of the company will probably receive the greatest attention during the term sheet phase. This is because the valuation determines the price of the equity to be purchased by the investor and, in turn, determines the amount by which the founders' ownership interest in the company will be diluted by the investment. The higher the valuation, the less the founders will be diluted in the transaction. When the company is at startup/early stage, haggling over valuation is as much an art as it is a science, and, as such, will involve extensive discussion.

An entrepreneur should try to get a basic understanding of the typical terms of a venture capital investment prior to receiving a term sheet. Here is a summary of some typical terms:

- Dividends: Each outstanding share of preferred equity may accrue dividends upon the purchase price paid by the investor for such share. This acts like an interest rate upon the principal that accrues (and sometimes compounds). Payment of accrued dividends is usually not required until (1) the company is sold, (2) the share is purchased back by the company (i.e., "redeemed") or (3) the governing body of the company (e.g., the board of directors)

declares accrued but unpaid dividends to be paid. If the preferred equity is convertible into common equity (see discussion of "Conversion" below), then dividends may also be payable (or convertible into common equity) upon such conversion of preferred equity.

- Liquidation Preferences: In the event of any sale, merger or winding up of the company for cash or stock (a liquidation event), the holders of preferred equity may be entitled to certain preferences.
  - The holders of preferred equity may receive in preference to the holders of the common equity (e.g., common stock) an amount equal to the purchase price (or a multiple of the purchase price [e.g., 2x]) paid by such investor for its preferred equity plus, if applicable, any accrued but unpaid dividends.
  - If the preferred equity is "participating preferred," then after return of its purchase price (and dividends), the holders of preferred equity will be able to share in the balance payable to the common equity as if the preferred converted into common as per its conversion rights (see discussion of "Conversion" below).
  - If the preferred equity is "non-participating preferred," then the preferred equity may be entitled to the greater of (1) its purchase price (and dividends) and (2) the amount that it

would receive if converted into common per its conversion rights (see discussion of "Conversion" below).

- Conversion: Preferred equity may be convertible into a number of shares of common equity determined by dividing the original purchase price (and, sometimes, accrued and unpaid dividends) by the conversion price. Usually the conversion price will initially be the purchase price (i.e., there is a 1:1 conversion ratio, or each one share of preferred equity will convert into one share of common equity), but the conversion price may be subject to anti-dilution price protection (see discussion of "Anti-Dilution Price Protection" below). Such conversion may be optional at the election of the holders, or mandatory upon a "qualified" IPO (e.g., an IPO priced at a certain level).
- Anti-Dilution Price Protection: The conversion price may be subject to adjustment downward upon the company's sale of any security at a price lower than the effective conversion price (i.e., a "down round"). Once the conversion ratio is adjusted, each one share of preferred equity will convert into more than one share of common equity. The anti-dilution price protection may be "full ratchet," in which event the conversion price will adjust to the lower price, or it may be "weighted average" protection, in which event the conversion price will be adjusted according to formula based upon

outstanding shares.

- Redemption: Holders of preferred equity may have the option to have the company redeem (i.e., repurchase) their holdings after a certain amount of time (e.g., five years from the closing). Effectively, redemption rights afford investors with a “way out” if an exit event does not occur. The redemption is usually based upon the purchase price (and could be a multiple of the purchase price) and, if applicable, accrued dividends.
- Preemptive Rights – Percentage Protection: To avoid getting diluted by a new capital raise, the holders of preferred equity may have a right of first refusal to purchase, pro rata, additional securities proposed to be sold by the company based upon the percentage of all outstanding stock held by such investors. For example, if an investor’s holding of Series A Preferred Stock equates to 10 percent of the company, and the company desires to commence an offering and sale of Series B Preferred Stock, the investor’s preemptive rights would allow the investor to purchase at least 10 percent of the Series B Preferred Stock.
- Protective Voting Provisions: Typically, the holders of preferred equity will require their consent prior to the company taking certain actions, which may include:

- Creating a class/series of equity that has liquidation preferences senior to their preferred equity
  - Mergers, sales, liquidity events, dissolutions, etc.
  - Incurring debt (outside ordinary course; thresholds)
  - Paying dividends
  - Repurchasing/redeeming equity
  - Adopting or amending stock option pools
- Drag-Along Rights: The investors will usually require all holders of equity in the company to be subject to drag-along obligations. If an unaffiliated third party makes a bona fide offer to acquire the company (whether structured as a purchase of equity, merger, consolidation or other reorganization) or substantially all of the assets of the company, and a requisite proportion of outstanding preferred equity (e.g., majority) elect to accept such offer, all other holders of equity will be required to sell their equity or to vote their equity to approve the sale of the company's assets in accordance with the terms of that offer. In other words, equity holders will be "dragged" to the closing. This provision ensures that a minority owner will not have the ability to hold up a deal that would provide liquidity to the investor.

- Rights of First Refusal and Co-Sale:
  - Holders of preferred equity may have a right of first refusal to purchase their pro rata proportion of any equity proposed to be sold by any other equity holders to third parties.
  - Holders of preferred equity may also have a right of co-sale that provides such holders with an opportunity to participate (pro rata) in any sale of equity by any other equity holder to a third party.
- Registration Rights: Holders of preferred equity may have the right to have their equity registered with the SEC to enable them to sell on the public market.
- Information Rights: Holders of preferred equity may require the company to deliver periodic financial statements and reports, some of which may be required to be audited.
- Board Rights: The investors will often want to ensure that a board of directors (or similar managing body) is of a certain size and composed of certain individuals. Often the holders of preferred equity will require that at least one board seat be designated by the holders of preferred equity.

Navigating the provisions and lingo of a term sheet can be an intimidating process, especially for those who have not gone through it



before. Therefore, if at all possible, an entrepreneur/startup should seek help and guidance from advisers who have experience in these matters. These may be lawyers, accountants or other business advisers – individuals who can explain the implications of each of the terms, and what is or is not typical. Ultimately, a productive term sheet negotiation with investors can set the stage for a fruitful partnership between the founders and investors.

### **About the Author**



[Gregg Lallier](#) is a principal at the law firm [Updike, Kelly & Spellacy](#) and is located at the firm's Hartford, Connecticut, office. His practice focuses primarily within the high-tech and venture capital industries. Gregg has represented both mature and emerging high-tech growth companies. He also regularly represents angel, venture capital and other institutional investors. You can contact him at <mailto:glallier@uks.com>.