

Venture Capital Term Sheets

Mind the Bridge

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Global Capital

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Schedule

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 - Purpose
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- IV. What the Terms in the Term Sheet Mean:
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 - Stock Purchase Agreement
 - Investors' Rights Agreement
 - Other Agreements (Co-sale/Voting Agreement)
 - Other Matters
- V. Startup Ecosystem Network

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I. Please Remember . . .

This is *not* legal advice—only a discussion of term sheets used by venture capitalists.

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II. Venture Capital Context.

1. Venture Capitalist Motives
2. Potential Conflict with Dreams
3. What is (Often) Successful
4. Coming Soon? Lean Startups
5. The Venture Process

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1. Understand VC Motives.

Venture Capitalists Are in a Market.

VC's compete for LP investment *in future funds*.

Therefore, they must build a reputation:

- Obtain and contribute to robust deal flow (help their ecosystem)
- Make at least prudent investments
- Make investments that impress partners

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2. Potential Friction with Dreams.

The “mythology” of Entrepreneurs means that they are involved in making their dreams come true. (What does “true” mean?)

- “It’s **MY** baby, **MY** dream, **MY** company.”
- Mythology may imply levels of risk that exceed those of the investors.

Venture Capital is 2 Levels of Using “Other People’s Money”

- Increases responsibilities & obligations.

At the end of the day, a company has to be built

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3. What Is (Often) Successful.

- **Team Over Idea:** VCs invest in *people* more than ideas, i.e., teams with:
 - Entrepreneurs who were funded before
 - The right technical/business/etc. people—especially those who can implement.
 - “holes” in the complete team but plans to fill them.
- **Hitting the Right ROI:** Meaningful ways to get to the desired multiple (ROI) in a limited period. (The higher the investment, the greater the multiple.)
- **Scalability:** Plans, technology and capacity to get to sales penetration sufficient for ROI or to attract the attention of acquirors.
- **Credible Ideas & People.** People and ideas *from* and *to* their ecosystem who will not embarrass them.
- **Substance Behind the Buzz.** Financials and operating plans that are realistic.

Let the Market Decide if You Are the Next Google . . .

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4. Coming Soon/Here Now? Lean Startups.

“Lean Startup Movement” is here.

- Catching the attention of investors: Accelerating angel and super-angel investment.
- \$50k and five weeks *not* \$2million and two years

MVP Model gives you:

- Quick market entry
- Quick market feedback
- Potential immediate revenues
- Closer to POC
- Demonstrate how team works together.

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5. The Venture Process

- **Presentations to Get the VC's Attention:**
 - **Elevator Pitch:** Broadcast the high-points of your startup.
 - **Executive Summary:** Elaborate on the elevator pitch.
 - **Pitch Deck:** Replaces the business plan—20-25 slides.
- **Ecosystem Referral:** Someone trusted makes the introduction.
- **Meet the VCs.** *Have the operating plan & financials ready.*
- **Term Sheet Submitted & Negotiated.** The debate begins.
- **Due Diligence Begins.** VCs scrutinize your company & your team.

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III. The Term Sheet in Its Context.

1. Term Sheet Content

2. The Purpose of the *Terms* of the Term Sheet

3. The Term Sheet: Negotiating Context

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1. The Term Sheet Content

Term Sheet: Summarizes the main terms of all of the other agreements:

- **Charter (Articles of Incorporation):** Public document filed with the incorporation state with major rights of shareholders. Most important document.
- **Stock Purchase Agreement:** Private agreement with company to issue shares.
- **Investor Rights Agreement:** Registration rights; director information access and voting control.
- **Co-Sale & Voting Agreements:** Right to acquire founders' shares; vote on initial board, etc.

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(continued . . .)

2. The Purpose of the *Terms* of the Term Sheet

- **Money matters:** percentage of company for X money.
- **Participate in the Future.**
 - Future rounds
 - IPOs and other exits
 - Limits on stock issuance
- **Keep the Focus of the Entrepreneurs.** Control does not (necessarily) come from percentage ownership but from class vote or director's vote.
 - Class votes or director approval on certain major transactions
 - Vote on annual and quarterly budgets
 - Right to remove entrepreneurs and buy back their stock

**VC's have fiduciary duties to their limited partners—
expressed in their control of the money.**

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3. The Term Sheet: Negotiating Context

1. **Starting Point:** Some entrepreneurs assume that a term sheet is a “fait accompli and that nothing can be changed.
2. **Everything is Negotiable, but . . . Market Power Counts.** Everything might be negotiable, but who has market power?
3. **Exploding Offers.** Sometimes there is a severe time limit—48 hours. Unfair to all parties and to the market.
4. **Friction Between “Plain Italian” & Legalese.** Term sheet does not have to be complicated legalese---but it usually is.
5. **Clarify Which Part is Binding.** Term sheets are usually not binding—other than the parts that are (“no shop” clause.)

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IV. What The Terms Mean.

1. Basic Information: Investors, valuation, etc.
2. Changes to the Charter (Articles)
3. The Stock Purchase Agreement
4. Investors' Rights Agreement
5. Other Agreements (Voting rights & Co-sale)
6. Other Matters

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1. The Term Sheet: Basic Information.

Offering Terms:	
<i>Closing Date:</i>	After due diligence (30-60 days); linked to “Lock-up” or “No Shop” provision.
<i>Investors:</i>	Entity + number of shares & percentage
<i>Amount Raised:</i>	Amount invested (+ retiring bridge notes)
<i>Price Per Share:</i>	“ Original Purchase Price ” (QPO) (reflected in Capitalization Table attached to Term Sheet).
<i>Pre-Money Valuation:</i>	Fully diluted pre-money valuation and fully-diluted post-money valuation (including employee option pool of x% post-money)
<i>Capitalization:</i>	Who owns what at the “end of the day.”

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Basic Information: Issues.

1. Pre-money Valuation: How calculated?

- *How it is calculated? DCF/Comps.*
- *Change from seed to series?*
- *Tell it before term sheet is offered?*

2. Employee Stock:

- *How much is not enough?*
- *Founders and employees different?*

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2. Changes to The Corporate “Constitution.”

1. Charter (Articles of Incorporation)

- Sets forth the basic rights of each class of stock (voting, liquidation preferences)
- Document filed with the Secretary of State of the state of incorporation (e.g., Delaware).
- Usually publicly available.

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2. Charter: VC Changes.

<i>Dividends & Liquidation</i>	<i>At least two classes of stock</i>
<i>Dividends:</i>	3 alternatives (Dividends are rarely paid until after exit).
<i>Pari passu with Common</i>	As paid on common, as if converted
<i>Liquidation, etc.</i>	Annual cumulative % on certain events (liquidation, redemption) (+ “pari passu”)
<i>Board Declared</i>	Dollar amount when declared by the Board

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2. The Charter: VC Changes (2).

Liquidation Preference: Principal + dividends paid 1st, and then, depending on alternative, Common, or as-converted basis. “Major Transactions” deemed to be liquidation events.

Voting Rights: As-converted basis as a single class (with Common) UNLESS a certain percentage remains outstanding and then can vote as a separate class to elect X directors.

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2. Charter: VC Changes (3).

<i>Protective Provisions:</i>	Preferred votes as a separate class on any direct or indirect “Major Transactions” (e.g., issuing/repurchasing stock; selling assets; unapproved debts; change in # of Directors).
<i>Optional Conversion:</i>	Subject to anti-dilution, converts 1:1 but taking into account accrued dividends, etc.

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2. Charter: VC Changes (4).

<i>Anti-dilution Provisions:</i>	<i>“Protected” or (compelled) participation in later rounds</i>
	<i>Weighted average:</i> Series A as a proportion of all outstanding stock after next round.
	<i>Ratchet:</i> Everything “re-priced.”
	<i>“Hammer”:</i> Participate or else . . . (See “Pay-to-play.”)

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2. Charter: VC Changes (5).

<i>The Other “Hard Stuff.”</i>	<i>More rights in the charter (Articles).</i>
<i>Mandatory Conversion:</i>	Pre-IPO or vote of class.
<i>Pay-to-Play:</i>	If they do not participate in next round, can lose preferences, be converted to common, and/or lose right to elect directors.
<i>Redemption Rights:</i>	Forced repurchase of Preferred shares (+ ROI). Tricky under Delaware law and subject to tax risks.
<i>Mandatory Conversion:</i>	Pre-IPO or vote of class.

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3. Stock Purchase Agreement

<i>Contract</i>	<i>Not too controversial An agreement with typical terms.</i>
<i>Representations and Warranties:</i>	Company reps & warranties, usually as to IP ownership. <i>Controversial:</i> Founders' R&Ws (rare in Series B and beyond; infrequent in A).
<i>Conditions to Closing:</i>	Due diligence, "Blue Sky," re-filed Articles (charter); sometimes an opinion of counsel.
<i>Counsel and Expenses:</i>	Usually capped (\$10-30k); negotiated on whether paid or not if deal is not consummated.



4. Investors' Rights Agreement.

1. Agreement as to rights of investors in reference to:

- Registration rights (e.g., IPOs)
- Information access and Director control
- Future participation (see SPA, anti-dilution rights, etc.)

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4. Investors' Rights Agreement (2)

Registration Rights: "Going public."

Registrable Securities:

Which shares can be registered?

Demand Registration:

1-2 requests to register, after a certain period and for a certain minimum amount.

S-3 Registration:

Registration of additional shares to sell into the market

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4. Investors' Rights Agreement (3)

Registration Rights (cont'd.):	"Going public."
<i>Piggyback Registration:</i>	Join another registration
<i>Expenses:</i>	Registration expenses paid by Company; legal capped.
<i>Lock-up</i>	<i>Investors prevented from selling their shares in a way that affects IPO aftermarket for a certain period.</i>
<i>Termination:</i>	<i>Registration rights terminate under certain circumstances.</i>

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4. Investors' Rights Agreement (4)

<i>Other Rights:</i>	Controls on the Company by Reading and Voting . . .
<i>Management and Information Rights:</i>	Quarterly and annual budgets, financial information; limited access to the company and its team.
<i>Right to Participate Pro Rata in Future Rounds:</i>	Subject to anti-dilution provisions in SPA.
<i>Matters Requiring Investor Director Approval:</i>	Preferred stock Director must be one of the Directors voting for material changes to the company (including hiring/firing/changing management team).
<i>Management and Information Rights:</i>	Quarterly and annual budgets, financial information; limited access to the company and its team.

4. Investors' Rights Agreement (5)

<i>Other Rights:</i>	
<i>Non-Competition and Non-Solicitation Agreements:</i>	Key management members might be required to sign, but in California and elsewhere they are unenforceable.
<i>Non-Disclosure and Developments Agreement:</i>	Transfers IP rights to the Company and protects their disclosure.
<i>Board Matters:</i>	Board participation; indemnification; D&O insurance.
<i>Employee Stock Options:</i>	Specifies amount of stock (% of outstanding) for employees.



5. Other Agreements

<i>Other Agreements:</i>	
CO-SALE AGREEMENT	<i>Right of first Refusal/Right of Co-Sale (Take-me-Along):</i> Company and investors can purchase stock from founders and major employees when offered.
VOTING AGREEMENT	<i>Among shareholders on certain votes that must be taken.</i>
Board of Directors	Specifies initial members of board of directors and voting.
<i>Drag Along Rights</i>	Founder and major employees have to vote for certain Deemed Liquidation Events if they have limited liability.

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6. Other Matters.

<i>Other Agreements:</i>	
<i>Founders' Stock:</i>	Buyback rights for certain %, declining over time. Very controversial.
<i>Existing Preferred Stock:</i>	“Clean up” provisions to correct errors at closing.
<i>No Shop:</i>	Restricts actions of founders to “shop” the deal for a certain period—30-90 days, usually 60.
<i>Expiration:</i>	When the term sheet will expire.

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Startup Ecosystem Network.

1. Italian startups often have difficulty obtaining professional services (e.g., advice from avvocati, commercialisti, notaio) at rates they can afford.
2. Several such professionals have formed an informal network to provide these services to startups at affordable rates.
3. We are looking for startups who wish to work with us on “case studies” on the methodology, so please contact me for more information.

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Thank You.

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