

## **TERM SHEETS: A BRIEF OVERVIEW**

### **The Term Sheet Process**

Rapidly growing companies typically have a limited ability to obtain working capital from banks and other traditional sources due to limited (or no) profitability and a predictably light balance sheet. Many companies must look to a professional venture capitalist ("VC") to provide growth capital. Company founders often meet VCs through industry and VC conferences, as well as, through introductions by trusted advisors. The key to securing venture capital on terms appropriately favorable to the company is to obtain advice from experienced legal counsel not only during negotiations, but even prior to starting the search for venture capital.

The management team should meet in advance with legal counsel that is not only familiar with the private placement process but is also experienced in all aspects of negotiating and drafting the necessary transaction documents. Early consultation with qualified counsel will enable the company to establish a realistic goal for valuation of the company, prepare a high quality business summary, and engage a VC in a manner that will encourage it to favorably review the company's summary financial and business information so that the VC can make an initial, typically verbal, investment offer. The VC will then prepare a formal term sheet setting forth the detailed terms of the investment. Proper negotiation of these terms is fundamental to obtaining a balanced deal that meets the expectations of both the company and the VC.

### **Terms of the Term Sheet**

A Term Sheet consists of many terms that are non-binding and binding, however, the term sheet is used as a guide for the attorneys to draft the final agreements. The five basic sections to a term sheet are:

- Value of the company
- Amount of investment
- Stock being purchased (Conversion features, Dividend preferences, Liquidation preferences, Anti-dilution protection)
- Investor rights ( Voting rights, Board of director rights, Registration rights)
- Binding provisions (No-shop clause, Confidentiality provisions, Due diligence)

### **Value of the Company**

The first term negotiated is usually the valuation for the company prior to the investment, also called the pre-money valuation. This pre-money valuation is used to determine the price per share to be paid by the VC. The VC will usually try to set a lower valuation on the company in an effort to obtain a lower purchase price and a greater ownership percentage of the company. A well prepared and

thought-out business summary, definitive and justifiable use of proceeds analysis, and a qualified management team will go a long way towards negotiating a higher valuation. Ultimately, however, valuation is highly subjective and very dependent upon how urgently the company needs the money, how much money it needs to raise, and the value perceived by the VC.

### **Amount of Investment**

The amount of investment that a company will receive is dependent upon two primary factors: how much money it can justify it needs to achieve its stated business goals, and the investment profile of the VC. A company should select a VC that has an investment profile that fits its working capital requirements, with the usual strategy being to raise enough money to enable the company to achieve set milestones in its business plan. If the company achieves its milestones and then requires additional capital, the company's valuation in the next round of financing will increase.

### **Stock Being Purchased**

In general, VCs purchase the capital stock of the company, and there are two types of capital stock: common stock and preferred stock. Common stock is what the founders and employees of the company receive for their ownership. Preferred stock is almost always purchased by VCs, because it provides the VC with preferential treatment above the common shareholders. These preferential rights can include mandatory dividends, payment before the common shareholders in the event the company is liquidated (liquidation preferences), the right to exchange their preferred stock for common stock (conversion right), and protection against a reduction in ownership interest in future equity transactions (anti-dilution provisions).

### **Conversion Rights**

Conversion rights allow the preferred shareholders to convert their preferred stock into common stock during certain events and automatically in the event of an IPO or certain other transactions. There is not much room for negotiation here by the company with respect to the conversion feature, although the company can negotiate for the right to force the investor to convert their preferred stock to common stock (thereby forcing the investor to give up all of the preferential rights reserved to the preferred stock). Generally, conversion rights are a 1-for-1 conversion of preferred stock for common stock. This allows the VC to take advantage of certain events by allowing the investor to cash out by selling common stock as part of the transaction.

### **Dividend Preferences**

A dividend is a payment made to the holder of the preferred

stock, usually based on a percentage of the amount invested. For example, a 6% dividend would obligate the company to pay the preferred shareholders 6% of the amount of their investment for each year they remain a preferred shareholder. If dividends are not paid, then become accrued dividends, also known as cumulative dividends, allowing the company the right to preserve cash flow and avoid an annual payment to the investor, but the accrued dividends must be paid to the investor before any dividends can be paid to the common shareholders. In addition, an investor can also negotiate to receive a participating dividend, which allows the preferred shareholders to receive both the 6% preferred dividend and any dividends declared on the common stock.

### **Liquidation Preferences**

The liquidation preference is used by VCs to maximize the return on their investment. In the event the company is liquidated (i.e., sold), the preferred shareholders will receive a portion of the proceeds based on their liquidation price per share, which could be their purchase price or a multiple of the purchase price. This reference is also triggered during events that are deemed liquidations, such as a merger, acquisition, change of control, consolidation of the company or a sale of all or substantially all of the assets of the company. A related right is the "participating" liquidation preference, which not only gives the investor their payment as a preferred shareholder, but also allows them to receive a portion of the proceeds that would be received by the common shareholders, as if the preferred stock has been converted to common stock. In this manner the investor is able to "dip twice" and receive many times their initial investment.

### **Anti-Dilution Provisions**

Anti-dilution provisions protect the VC from having its percentage ownership of the company reduced in the event the company sells equity in the future at prices lower than the price the investor paid. There are two basic formulas to protect the investor against dilution: full ratchet and weighted average. The full ratchet approach is very heavy handed because the VC is entitled to receive additional equity in the company so that its original purchase price is effectively reduced to the lower price paid by the new investor (and the old investor does not have to pay any additional money to receive the additional equity). This results in the substantial reduction of the percentage ownership held by the founders of the company. The weighted average formula is much more founder friendly

because it adjusts the number of shares the investor receives based upon the weighted average effect of the new lower price on all the shareholders, which reduces the percentage ownership that the founders must give up to protect the old investor.

### **Investor Rights**

The investors will also receive certain rights to oversee the operations and management of the company, such as the right to have final vote on certain company actions, one or more seats on the Board of Directors, the right to receive detailed financial information, and the right to dictate various operational decisions such as employee and executive compensation, issuance of stock options, starting or terminating lines of business, as well as the right to veto other actions of the company that are deemed important by the investor.

### **Binding Terms**

While all of the terms highlighted above are instrumental to the consummation of the investment, they are usually not binding on either party and can be further negotiated during the drafting of the transaction documents (although substantial deviation from the agreed upon terms from the term sheet is generally disfavored and will not usually be tolerated by the VC). The term sheet will, however, contain a number of terms that are binding on the parties, including a "no-shop" clause, the "confidentiality" clause, and the obligation to permit and assist in due diligence. The no-shop clause prevents the company from seeking to negotiate better terms with another investor and is usually for a period of 90-120 days. The confidentiality provision protects the company from the investor sharing its confidential financial and business information with anyone not involved in the evaluation of the investment. Finally, the due diligence clause gives the investor the right to review the company's financial and business information so that it can determine if there are any business, legal, or financial issues that pose a problem for the investor.

### **Conclusion**

These are just a few of the more significant terms that a company can expect in a traditional VC term sheet, however, there are many other provisions that have not been reviewed due to their complexity. Any company that is seriously considering pursuing venture capital is well served to obtain the advice of qualified counsel throughout the entirety of the process. Poor advisors can not only result in a company negotiating a bad investment, it could also cause the company to lose the investment opportunity altogether.

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