



**streetwise: HANSON, BRIDGETT, MARCUS, VLAHOS & RUDY, LLP**

## Negotiating a Venture Capital Term Sheet

**W**hich terms in a venture capital term sheet are negotiable? All of them. Yes, you may frequently hear that certain terms are “market” and that there is no room to negotiate in connection with such terms if you want VC funds. But the reality is that the term “market” is often over-used in the venture capital world. It is certainly true that a number of provisions are almost always found in term sheets, and are “market” in so far as their prevalence in equity financings. The parameters of such provisions, however, are frequently changing and are almost always open to some amount of negotiation. The market is fluid, changing over time, from industry to industry and often deal to deal. As well, the more leverage a company or investor has in any particular transaction, the less “market” will matter.

This article discusses ten provisions you can almost always expect to see in a VC term sheet, as well as the parameters of such provisions as far as negotiations are concerned.

### 1. Valuation

Valuation is probably the most important issue a company will face in negotiations with VCs – and the most negotiable, especially for early stage companies. Valuation refers to the value of your company before investment, and determines the price of new money coming in. The lower the value that is placed on your company, the higher the cost of VC money since your ownership of the company will be diluted to a greater extent. Valuation is negotiable because it is nebulous and can be estimated in any number of ways. The outcome of negotiations over valuation will depend largely on your knowledge of your company, your market and your competition. You will need to do your homework and attempt to ascertain valuations used for similar companies that have recently completed equity

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financings. You should be able to conduct this research online, and by inquiring with acquaintances in your industry. You should also be able to demonstrate the value of your company at some point in the future. If your company is in the early stages, it may show tremendous potential but may not see any earnings for some time and losses may be likely for the initial years of operation. Thus, you should develop financial projections setting forth the value of your company at or around the time that VC’s will likely exit, typically 4-7 years after an initial investment is made. This can then be discounted to present value, which may serve as the basis for valuation of an investment. The stronger the case that you are able to make, combined with empirical evidence to back it up, the higher the valuation is likely to be.

### 2. Liquidation Preference

For the risks associated with investing in an early stage company, VCs will typically require a premium on their money. Liquidation preference refers to the right of an investor to receive a return prior and in preference to other investors on liquidation or sale of the company. Liquidation preferences are usually expressed as

a multiple, e.g., 1x or 2x, meaning a return of one time (1x) or two times (2x) original investment. In the early part of this decade, liquidation preferences were known to reach 3x or higher, meaning that certain VCs were entitled to receive three times their investment before founders and others received anything! Today, it is much more common to see liquidation preferences of 1x, but the multiple will really hinge on the risk perceived. You should also try to limit the definition of liquidation to exclude such things as subsequent financings in order to avoid paying a liquidation preference in the first place.

### 3. Participation

The next question is whether after receipt of a liquidation preference VCs are entitled to participate with other stockholders in remaining proceeds. This is not uncommon, especially with lower liquidation preferences. The higher the liquidation preference, the more you should focus on eliminating or receiving some type of cap on participation, meaning that once a certain dollar amount is allocable to VCs on liquidation, their participation in the balance will cease.

### 4. Antidilution Protection

In most instances VCs will require protection against dilutive stock issuances in the future. This protection usually takes the form of adjustments to the price at which preferred stock (the type of stock that VCs typically receive) converts into common stock, meaning that a VC may ultimately be entitled to receive a larger piece of the company. The negotiation concerning antidilution protection usually concerns the adjustment mechanism used. A broad-based weighted average adjustment mechanism is the most company-friendly and considers the effect of a dilutive issuance based on the broadest

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possible base of existing equity interests. Narrow-based weighted average may exclude existing interests such as options or warrants and results in a larger reduction to the conversion price. Full ratchet means that the conversion price of preferred is adjusted downward for a dilutive issuance on a dollar-for-dollar basis, and is the least favorable to the company. The effects of anti-dilution protection can be mitigated by eliminating certain issuances from the definition of “dilutive issuances.” For instance, stock that is anticipated to be issued to employees or service providers at below market prices for incentive purposes might be eliminated, meaning that such issuances will not affect conversion price.

## **5. Dividends**

In most instances, VCs are not investing in early stage companies with any expectation of dividends. Thus, the most common dividend provision provides that dividends will be paid when, as and if declared by the board of directors. You should resist cumulative dividends provisions, providing that dividends will cumulate at a certain rate (e.g., 8%) until paid, though some investors will insist on such terms.

## **6. Protective Provisions**

VCs will often hold a minority interest after completing an early stage investment. As a result, it is common for VCs to receive special voting rights that permit them to block certain actions or events. For instance, it is not at all uncommon to require a separate preferred vote on amendments to organizational documents that would affect preferred shareholder rights. Founders should focus on limiting such protective provisions to events that directly impact the rights and/or investment by VCs and avoid provisions that give VCs control over general business and corporate decisions. This is often a fine line. If and when additional series of preferred shares are sold, companies should endeavor to ensure that protective provisions apply to

all such series voting together as a class, rather than separately to each series.

## **7. Redemption**

VCs may negotiate the right to require a company to repurchase their stock at some point in the future. This makes an investment similar to debt in many respects. While such a right is not likely to be exercised unless an investment has or is heading south for all, you should resist such a right on the grounds that you are looking for an investor and partner, not a lender.

## **8. Pay-to-play**

Pay-to-play provisions are designed to encourage the participation of existing investors in subsequent rounds. There are two basic pay-to-play provisions to consider. The first eliminates anti-dilution protection if an investor fails or refuses to invest in a subsequent round with a per share price less than that paid by the investor. The second forces conversion of preferred stock held by VCs into common, resulting in the loss of all preferences and privileges appurtenant to preferred stock if the investor fails or refuses to participate in a subsequent round. Pay-to-play provisions are not as common now as they were a few years ago but are sometimes supported by VCs who want to encourage the participation of all investors in subsequent rounds.

## **9. Vesting of Founder Stock**

VCs will want to ensure that founders have contributed sufficient value to justify a proposed VC investment and are incentivized to stay with the company at least until certain milestones are achieved. It is not uncommon, however, for founders to provide that their stock is owned and fully vested upon issuance. To ameliorate concerns, VCs often request that founders agree to subject their shares to vesting provisions, for instance 25% a year over the next four years. Founders should at a minimum request credit for time worked prior to investment and consider requesting a shorter vesting period (e.g., 3 years rather than 4) and

monthly increments. Founders should also request acceleration in the event of a change in control or termination without cause.

## **10. Board Composition**

Early stage companies should endeavor to keep their boards fairly lean. That said, VCs will almost always want at least one seat on the board and perhaps more depending on the amount invested, the number of investors and the level of control sought. For an early stage company, you might negotiate for a three person board with one seat filled by a VC representative. Alternatively, and not at all uncommon, is a five person board with two seats filled by the vote of common, two filled by VCs and the final seat filled by an industry expert acceptable to both the preferred and the common. Negotiation will of course focus on the final seat and will in all likelihood concern such things as whether preferred and common vote together as a single class or separately. The outcome of such negotiations will, again, depend on the amount invested and the level of control sought or required.

The key point to remember is that it doesn't hurt to ask. You should work carefully through the ramifications of each and every term in a term sheet, asking how it may affect company performance, management, incentives for founders and employees and the possibility of raising additional funds in the future. If you do not like the answers to your questions concerning any term or condition, then the parameters of these terms and conditions should be explored and you should request changes to terms that you believe may be difficult to live with on a going-forward basis.

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