

National Association of Seed and
Venture Funds

Swing for the Fences -- Seed Investing for
Entrepreneurs

NEGOTIATING THE TERM SHEET
By Mark Shaffer

INVESTMENT DOCUMENTATION

- Business Plan
- PPM
- Term sheet
- Share Purchase Agreement
- Shareholder Voting Agreement
- Corporate Articles and Bylaws

PREPARATION - I

- Good Support
 - Hire a good lawyer and financial adviser
 - Look for experience on both sides, integrity, and compatibility
 - Listen
- Focus
 - Some terms matter more than others
 - Valuation, type of security, board composition, dilution, controls, and founder return and rights.
- Clean Security Structure
 - Price is important, but a simple attractive capital structure will greatly will facilitate follow-on investment
- Plan B
 - Work with more than one investor
- Quality
 - Quality investor increases value

Preparation - II

- Vetting is mutual
- "We always do it this way!" Every deal is different
- Organize multiple investors
- Follow-on commitments
 - increases the likelihood of success
 - mirrors "pre-emptive rights."
- Term sheet negotiation structures relationship
- Investment equation and terminology
 - An educated consumers make better decisions
- "Know when to hold 'em. Know when to fold 'em."
 - Look for philosophical, financial, and personality compatibility
 - Study negotiation styles
 - Demand integrity

INVESTMENT STRUCTURE

Stock, options, warrants and debt

- Stock distributes equity
- Option is right to buy (exercise) at formula (strike) price – longer term (10 years)
- Warrants function as short term options, tradable, and non-taxable events
- Warrants and options are accounted for as stock equivalents
- Warrant coupled with debt creates original discount measure tax problems
- Warrants “in the money” for three months can be deemed exercised
- Warrant are exercised by issuance of new stock at exercise price and use of proceeds to purchase stock at market price
- Debt – notes, bonds, leases, mortgages
- Dividends
- Preferred Stock
 - Pre-emption
 - Redemption
 - Liquidation
 - Anti-dilution
 - Drag-along, tag-along and piggy-back
 - Retraction
- Voting, Board representation, Information, FFF safeguards, Employees

FINANCIAL COMMITMENT

- Single investment
- Scheduled investment
 - Calendar controlled
- Milestone based investment
 - Early stages
 - Further rounds dependant upon demonstrable ability to meet milestones
 - Difficult to avoid ambiguity in standards
 - Bright-line can be self-defeating
- Draw-down investment
 - Investor controlled

EQUITY AND DEBT STRUCTURE

- Convertible Preferred Shares or Debt
 - maximize security and provide valuation upside
- Impact on company P&L statements implicating business activities and follow-on financing
- Tax implications

INVESTOR RIGHTS - Conversion

- Preferred shares may voluntarily convert to common, usually 1:1, subject to anti-dilution provisions
- Preferred may be compelled to convert by automatic conversion provisions
 - IPO meets set criteria
 - Gross proceeds
 - minimum threshold,
 - designated exchange listing,
 - shares issued at fixed minimum multiple of investment price
 - Majority class vote
 - Pay to play financing round

INVESTOR RIGHTS - dividends

- Entity goal is to limit dividends to preferred pro rata common distribution
- Investor goal is to secure both preferred and pro-rata common distributions, the double dip
 - Cumulative or non-cumulative dividend based upon valuation
 - Preferred shares cumulative dividend rights of 8% per annum payable upon liquidation, increases the liquidation preference to an amount greater than the negotiated multiple.
- Multiple class calculations

Investor Rights - Voting

- ❑ Preferred shares vote with common on “as-if” converted basis.
- ❑ Preferred shares vote separate class rights
- ❑ Class voting requirements for any major transaction, redemption, repurchase of shares, changes in board size or composition, issuance of dividends, debt commitment
- ❑ Preferred shares may override class votes on specified matters, i.e., asset sale or other liquidation events

Investor Rights - Liquidation

- Liquidation events: sale of substantially all assets or change in control, dissolution and wind-up
- Change of control based upon future financing to cash out founders and initial investors may or may not be an “exit” or “liquidation event”
- Conversion to common v secure preference benefits, followed by conversion, and participate in payout schedule
- Liquidation fully participating, non-participating or capped participating
 - Fully participating preferred shares receive their preferred payout of 1x-3x depending on their entry round, and then participate ratably with the common
 - Capped participating preferred shares also receive their preferred payout and then participate with common shares up to a capped return.
 - Non-participating preferred shares receive the preferred payout, but not common payout

Investor Rights - Anti-Dilution

- Weighted average anti-dilution provisions reduce ratchet impact in down rounds
 - Simple weighted average ratchet adjusts the old issue preferred share downward
 - The old issue shares are re-priced to a weighed average of old issue price and the new issue price. The number of shares issued to an existing investor is increased to make up the value difference
 - A broad-based ratchet averages the share price over previous rounds (total investment) divided by the number of shares of all rounds before adjusting for ratchet shares
 - A narrow-based ratchet uses only outstanding common stock as the denominator of the formula for determining the new weighed average price
 - Full ratchets - lowest sale price
 - Used in bad investing climates to protect/incentivize founders and early round investors
 - Later round investors view as a negative.
 - Option reload is a less onerous incentive.
- Ratchet exclusions diminish ratchet impact and implicate investor control concerns
 - approved employee SOP shares
 - subdivision shares
 - convertible securities
 - non-financing shares (equipment/banks)
 - strategic shares
 - acquisition consideration shares
- Pay-to-play provisions require existing investors to participate in subsequent finance rounds
 - Lose future rights to participate
 - Downgrade preferred
 - Convert to common, and lose all of the preferential rights on original investment

Investor Rights - Retraction

- Bail out at discount price
- Frequently bundle preferred with common in buy-back

Investor Rights- Board Participation

- Board size/composition/quorums
- Investor representation
- Class representation
- Board related rules and meetings
- Committees

Investor Rights - Information

- Shareholders with minimum threshold
- entitlement to monthly/quarterly financial statements
- budget information
- cap table
- disclosures re litigation etc.

Investor Right– Control Decisions

- Shareholder input or control of typically director or management decisions
 - asset sales
 - debt
 - security interests
 - executive staff retention
 - business changes
 - selection of IPO underwriter or sale financial advisor

Investor – Pre-emption

- ❑ Participation in future equity offerings
- ❑ on pro-rata basis
- ❑ assuming conversion of all preferred, options and warrants to common shares.

Investor Rights - Registration

- ❑ Demand subject to minimum raise and number of events
- ❑ blackout period
- ❑ piggyback registration (subject to rights of company and underwriters to reduce the proposed number to be registered)

Investor - ROFR

- ❑ Preferred shareholders right to acquire Founder common shares prior to sale or transfer to third party
- ❑ Generally contain pro-rata and time expiration provisions

Investor Rights- Drag Along, Tag Along, and Piggyback rights

- ❑ A set percentage of shareholders can require all shareholders to accept a purchase offer. Percentage should be set on a fully diluted basis implicating conversion, warrant, and option holders.
- ❑ Lower threshold for investors and higher threshold for founders and key employees
- ❑ Shareholders right to sell to third party at same price offered to other shareholders

ENTITY RIGHTS - Redemption

- Entity rights to redeem preferred shares may include preferred holder protection period and expiration date.
- Class or less
- Payment in full or by schedule
- Security

Employees

- ❑ SOP rights and protections
- ❑ Key person insurance
- ❑ Key person ratification of NCA-NDAS-IPR agreements

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