SQUIRE PATTON BOGGS
Venture Law Meetup

Understanding Venture Capital Term Sheets

Venture Law Meetup Series
February 2020

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Outline

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- Stages of a Company's Growth and Funding Lifecycle
- Types of Venture Capital Investors
- What Goes into a Term Sheet
  - Economic Terms
  - Control Terms
  - Exit Terms
  - Miscellaneous Terms
- Next Steps and Timing

Stages of a Company's Growth

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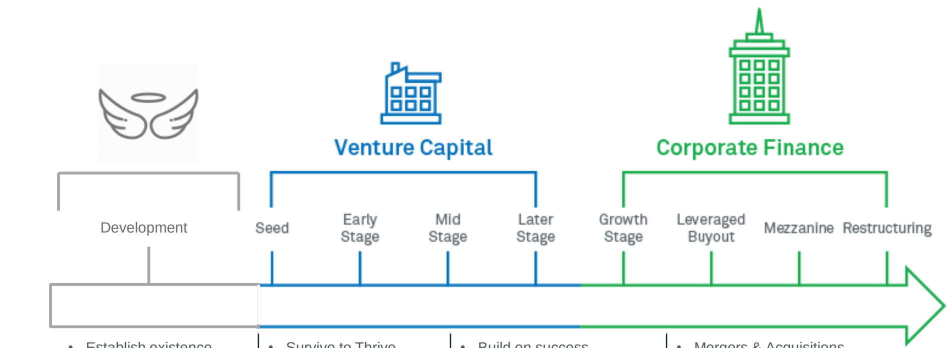

Actions	• Establish existence • Proof of Concept • Refine Business Plan	• Survive to Thrive • Establish and retain customer base • Build consistency in product / service	• Build on success • Fine tune Business Plan • Streamline / scale-up operations	• Mergers & Acquisitions • Joint Ventures • Spin-Offs • Restructuring
Capital	• Cash Savings • Personal Loans • Friends and Family • "Super Angels"	• Angel Investors • Venture Capital • Crowd Funding	• Venture Capital • Business Line of Credit	• Private Equity • Business Lines of Credit

Company Funding Life Cycle

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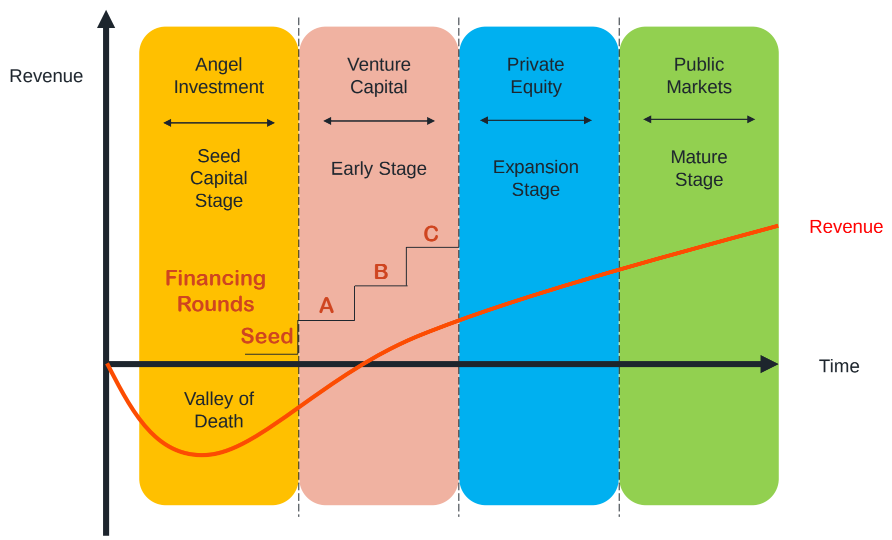

Types of Venture Capital Investors

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- **Seed Stage Investors**: Help get a company off the ground and reach POC
  - Revenues: $0 to $1 million
  - Typical investments: $100,000 to $1 million
- **Early Stage Investors**: Help a company that has successfully proven its concept to accelerate its sales and marketing efforts
  - Revenues: $1 million to $10 million
  - Typical investments: $1 million to $5 million
- **Growth Stage Investors**: Help a company that is already on fire to expand
  - Revenues: $10 million to $50 million
  - Typical investments: $10 million to $50 million

- **"Club Deals"**: Typically, a lead investor will engage with the founder, conduct due diligence, arrive at a valuation, negotiate terms and commit to funding a portion of the round. Then a group of followers will join the round.

How Do VC Investors Structure Their Investments?

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- Investors provide cash in exchange for a new class of preferred stock with special rights (versus the founder shares or other common stock)
- These rights typically involve a lot of protections, even for a minority-stake shareholder
- A core protection is the liquidation preference
  - In the eventual sale of the company, the investors get paid before any other shareholder gets paid, including the founders
  - Downside protection for the investors and leverage to make sure that the investor will have an opportunity to realize a return on their investment

Be aware of the trade-offs between accepting external funding and giving up equity when raising capital from VC funds.

What is a Term Sheet or Letter of Intent?

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- A key document in a VC transaction
- First major step in any transaction – when material terms of deal are negotiated and agreed to
- Not a binding agreement (except see below) to fund capital because it is subject to agreement on final documents and the investors completing their due diligence of the company
- Some provisions are legally binding:
  - Confidentiality obligations
  - Exclusive negotiation period
  - Payment of expenses
- A road map for lawyers to draft the final documents

Deals rarely vary from the term sheet

What Goes into a Term Sheet?

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Economic Terms

- Type of Security
- Per Share Price
- Valuation of Company
- Liquidation Preference
- Capitalization
- Representations & Warranties

Control Terms

- Investor Approval Rights
- Board Representation and Approval Rights
- Anti-dilution Rights
- Participation Right
- Information Rights
- Founders' Stock Vesting
- Restrictive Covenants

Exit Terms

- Drag-along Rights
- Co-sale Rights
- Redemption Rights
- Registration Rights

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Economic Terms

Terms that Impact Economics

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- Types of Securities:
  - SAFE
  - Convertible Note
  - Convertible Preferred Stock
- Price Per Share

$$\frac{\boldsymbol{Pre - Money\ Valuation}}{\boldsymbol{\#\ of\ Oustanding\ Shares\ Pre - Investment}}$$

- Pre-Money Valuation
  - January 2018 VLM – Business Valuation Basics for Early Stage Companies
- Liquidation Preference
- Capitalization

Valuation: Example

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- **Example**: VC investor says that he will invest $1 million in the company at a $10 million pre-money valuation
  - Facts: 900,000 shares issued, 100,000 shares reserved for stock options
  - What percentage would the VC investor own after he makes his $1 million investment?
  - Answer:
    - 9.09% on a fully diluted basis (i.e. shares issued + stock options reserved)
    - 10% of voting power (based only on shares issued)

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Valuation: Negotiation Points

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- **Contested Point**: Number of shares outstanding on a "fully-diluted basis"
  - This generally includes all outstanding common stock, preferred stock, options, warrants and other convertible securities as if fully exercised or converted
  - But do "outstanding options" include only issued options (but not unissued options)?
- **Who Will Bear The Cost Of Dilution?**
  - Investors: Will argue for a larger fully-diluted basis (i.e., one including the unissued options) so that the existing common stockholders will assume the diluting effect when those options are issued and exercised
  - Company: Will argue for a sharing of the diluting effect of the unissued options equally between the existing common stockholders and the new investors

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Liquidation Preference

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- Applies when a "**liquidity event**" occurs, which includes sale of the company to a strategic buyer or private equity firm, IPO or dissolution of the company
- When distributing the proceeds from a "liquidity event," investors who hold preferred stock, have the right to get a certain amount of money back before other shareholders get anything (hence the "preference")
- Typically early rounds set a precedent for later rounds, so early investors that are too greedy on terms may live to regret it
- **Three types of preferred stock in a liquidity event**:
  - Non-Participating Preferred
  - Capped Participating Preferred
  - Uncapped Participating Preferred

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Liquidation Preference: Term Sheet Language

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- **Non-Participating Preferred**: "First pay the original purchase price on each share of Series A Preferred Stock. Thereafter, the balance of any proceeds will be distributed pro rata to Common Stock"
- **Capped Participating Preferred**: "First pay the original purchase price on each share of Series A Preferred Stock. Thereafter, Series A Preferred Stock participates with Common Stock on an as-converted basis until Series A Preferred Stock receive an aggregate of [2X, 3X, etc.] the original purchase price"
- **Uncapped Participating Preferred**: "First pay the original purchase price on each share of Series A Preferred Stock. Thereafter, Series A Preferred Stock participates with Common Stock on an as-converted basis"

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Liquidation Preference: Example

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- **Example**:
  - Assume a $5M Preferred Stock investment at $20M pre-money valuation (resulting in the preferred stock investors owning 20% of the company)
  - Two years later, the company is sold for net proceeds equal to $40M without any additional shares issued after the Preferred Stock investment
  - The Preferred Stock have a 1X multiple
- "**Non-Participating Preferred**" means the Preferred Stock gets the greater of $5M preference and amount would receive if converted to Common Stock (i.e., 20% of $40M, or $8M)
  - Result: $8M goes to the Preferred Stock (20%) and $32M goes to the Common Stock (80%)
- "**Capped Participating Preferred with a 2X Cap**" means the Preferred Stock gets $5M preference plus 20% of the remaining $35M up to a total 2X cap (or $10M)
  - Result: $10M goes to the Preferred Stock (25%) and $30M goes to the Common Stock (75%)
- "**Uncapped Participating Preferred**" means the Preferred Stock gets $5M preference plus 20% of the remaining $35M (or $7M)
  - Result: $12M goes to the Preferred Stock (30%) and $28M goes to the Common Stock (70%)

Other Economic Terms

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- **Capitalization**: The capitalization table may be negotiated
  - Has prior money been invested? On what terms?
  - Have employees / consultants been promised equity?
- **Dividends**: If the investment is intended to yield a certain return
  - Cumulative dividends are dividends that automatically accrue
  - Noncumulative dividends will only accrue, and be payable, if the board of directors of the company declares the dividends
- **Reimbursement of Investor Expenses**: Investors often will require reimbursement for the legal, diligence and administrative costs of the financing, up to a predetermined cap
  - Out-of-pocket diligence and administrative fees v. legal fees
  - Reimbursable only upon the successful closing of the investment or regardless of whether the investment closes?

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Control Terms

Special Investor Approval Rights

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- **Approval Rights**: Investors often request special approval rights with respect to certain matters of particular significance to their investment. The company cannot:
  - Merge, sell its assets or implement any fundamental changes to its business
  - Amend its charter or bylaws
  - Create or issue any additional shares of stock
- Protective Provisions, particularly those with high vote thresholds, have the potential to expose the company and the investors to opportunistic behavior by other investors

Try to ensure that each protective provision is reasonable in light of the expected benefit to the investors and the administrative burden on the company

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Board Representation and Approval Rights

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- **Board Seat**: Investors require one or more board seats
  - Keep board size manageable – bigger is not always better
  - Sometimes a board observer may be better rather than a board seat
  - November 2019 VLM – Managing Your Board of Directors
- **Director Approval Rights**:
  - Incur debt in excess of $X, guarantee debt of others or make loans to others
  - Enter into a related party transaction
  - Hire, fire or change pay of executive officers
  - Change business of the company
  - Sell or license IP or other key assets (other than in the ordinary course)
  - Enter into material agreements involving payment in excess of $X

Investors must walk a fine line between protecting their investment and encouraging corporate growth

Anti-dilution Protection

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- **Anti-dilution Protections**: Protects investors in a future “down round” – when new money is invested at a pre-money valuation (or price per share) that is lower than the previous round’s post-money valuation
  - Changes the conversion price used to calculate the number of shares of common stock issued if/when a share of preferred stock converts
  - Common shareholders and founders do not have these protections
- **Types of Adjustment**:
  - Full ratchet
  - Weighted average
  - None

- **But Certain Issuances will not Trigger an Adjustment**:
  - Stock issued pursuant to an equity incentive plan
  - Stock issued in connection with equipment leasing or commercial borrowing

Participation Rights

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- **Participation Rights** (aka "Preemptive Right"): Right given to certain stockholders to purchase shares in a new financing round in order to maintain their percentage ownership
- **Pay-to-Play**: Failure of investors holding Preferred Stock to purchase their pro rata amount of shares in a new financing round results in penalties (applies in a "down round")
  - Loss of board seat
  - Loss of anti-dilution protections
  - Loss of future participation rights
  - Mandatory conversion to common stock

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Other Control Terms

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- **Right of First Offer**: Right for company or preferred stockholder (or both) to receive notice if specified stockholders (i.e. Founders) decide to sell and to make an offer, but the company/preferred stockholder is under no obligation to accept the offer
- **Right of First Refusal**: Right to purchase shares for sale by any specified stockholder (i.e. Founder) based on a third-party offer already received by such stockholder

Understand the process of transferring shares in the future and plan for expected transfers

- **Information Rights**: Rights to receive certain information, subject to certain exclusions, confidentiality obligations and major investor thresholds
  - Certain financial statements
  - Be sure to exclude smaller investors and competitors

Don't over-commit to when the company can deliver information

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Exit Terms

Exit Protections for Investors

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- **Drag-Along Rights**: Ability of a majority stockholder to force all stockholders to go along with a sale of the company meeting certain conditions
- **Co-Sale Rights** (aka "Tag-Along Rights"): Ability of a minority stockholder to sell along side a majority stockholder
- **Redemption Rights**: Ability of an investor to require the company to redeem the investor's preferred stock
- **Registration Rights**: Rights for public offerings of the investors' shares
  - Demand registration right
  - Piggyback registration right
  - Lock-up agreement

Other Key Terms

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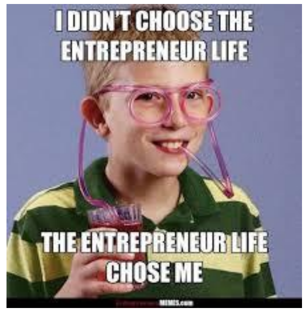
- **Vesting of Founder Shares**:
  - Investors will want founders' shares to be subject to vesting, even when shares have been purchased for value or have previously vested, to create an incentive for the founders to remain committed to the company (i.e., "human capital")
- **Non-Compete and Non-Solicitation**: Investors often request that the founders and key employees execute non-compete and non-solicit agreements in order to protect their investment in the company
- **Confidentiality and Invention Assignment**: Investors often request confirmation that the founders and key employees execute confidentiality and invention assignment agreements
- **Key Person Insurance**: Investors may require the company to maintain "key man" life insurance on the lives of the founders or key employees



Other Key Terms

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- **Use of Proceeds**
- **No Shop** (Binding Provision)
  - As an incentive for the lead investor to invest time and money into a due diligence process with the company, the company cannot look for investors for several weeks
- **Confidentiality** (Binding Provision)
- **Expiration Date**
- **Governing Law** (Binding Provision)
- **Signatures**
  - Although most of the provisions contained in the term sheet are not legally binding on the parties, it is nevertheless valuable to have it signed by all of the parties

"Sign here, initial here and emoji here."

Next Steps and Timing

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- **Conditions to Closing**
  - Satisfactory legal and financial due diligence
  - Compliance with federal and state securities laws
  - Filing of amended charter
  - Entry into final agreements

- **Closing**
  - The term sheet should set forth the anticipated closing date of the financing
  - The term sheet should set forth whether the company will allow additional investors to join after the initial closing within a reasonable time period (e.g., 60-90 days or more)
    - This allows the company to give investors flexibility in coming up with capital and to raise funds from smaller investors that have not committed prior to the initial closing
  - Sometimes the parties will agree to stage or "tranche" an investment in the company, whereby the investors will make an initial investment in the company and then agree to invest additional if the company reaching certain milestones (e.g., financial targets, patent approvals or the execution of key customer contracts)

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Some Final Thoughts…

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- **Generate Scarcity and Interest**
  - Try to land multiple term sheets to increase your leverage and options
- **Choose Your Investors Wisely**
  - Like a marriage with kids involved, you will be with them for a long time
  - Think about how a given syndicate of investors positions you for the next round
  - Remember that not all venture capitalists are the same
- **Choose Your Fights Wisely**
  - Make sure you know what really matters to you and market dynamics
- **Choose Your Legal Advisors Wisely**
  - This stuff gets complicated fast
  - Hire a lawyer with experience
  - And do it early - before negotiating the term sheet!

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Definitions

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- **Types of Securities:**
  - **Simple Agreement for Future Equity (SAFE)**: an investment that is neither equity or debt but converts into shares of the company in the future upon defined circumstances
  - **Convertible Note**: it is debt with an equity feature because it converts into shares of the company in defined circumstances
  - **Convertible Preferred Stock**: it is equity ownership in the company that has preference over common stock (which is typically issued to the founders) when it comes to dividends, distributions, liquidation and redemption. Many times, it tends to be convertible into common stock – with all the upside
- **Pro Forma Capitalization**: Amount that each investor plans to fund and the percentage that each investor will own in the company after the financing is completed (pro forma capitalization)
- **Pre-Money Valuation:** the dollar value given to the company before the new money is invested
- **Post-Money Valuation:** the “pre-money valuation” + the amount of new money invested

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Definitions (cont.)

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- **Registration Rights:** Rights for public offerings of the investors’ shares
  - **Demand registration right:** Right to demand the registration of the investors’ shares by the company to sell publicly
  - **Piggyback registration right:** Right to register and sell the investors’ shares at the same time when the company registers to sell its shares
    - In general, companies will want to limit the scope of any registration rights due to the time, expense and liability associated with registrations
  - **Lock-up agreement:** Typical for investors to agree to a standard market stand-off agreement or a “lock-up” agreement, in which the investors agree not to sell their shares for a certain period of time after a public offering

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Related VLM Resources

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- November 2019 VLM – Managing Your Board of Directors
- January 2018 VLM – Business Valuation Basics for Early Stage Companies

March Venture Law Meetup

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Budgeting for Your Startup's Success

- **Date/Time:**
  - **Live:** Friday, March 6, 2020 – 8:30-10 a.m. ET
  - **Webinar:** Monday, March 9, 2020 – 1-2 p.m. ET
- **Location:**

  MidTown TechHive

  6815 Euclid Ave, Cleveland, OH 44103

Upcoming NEO Start Up Events

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FINANCING & MILESTONES

Setting Your Financing Goals + Milestones
Lunch and Learn
February 28, 2020 at 12pm
CLEWorx, 1400 E 105th

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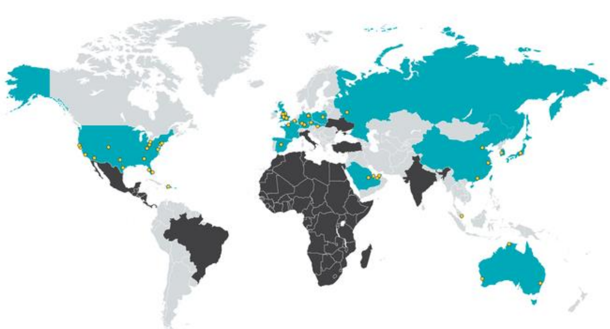

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