Lecture 10

Term Sheet

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Outline

- What is term sheet?
- What terms
- Example of a term sheet

Private Equity

- The generally accepted term to describe the industry as a whole, encompassing both
  - management buy-out
  - and buy-in activity
  - and venture capital which relates exclusively to the seed through to expansion stages of investment.

Term Sheet

- A term sheet is a document which outlines the key financial and other terms of a proposed investment.
  - Basis for drafting the investment documents
  - Not usually intended to be legally binding
  - Contain certain conditions which need to be met before the investment is completed – known as **conditions precedent**

Term Sheet encompasses..

- Subscription Agreement: number of class of shares, payment terms and representations and warranties given by disclosure letter.

- Shareholder's or Investors' Rights Agreement: investor protections, including consent rights, rights to board representation and non-compete restrictions.

- Articles of Association: rights attaching to the various share classes, the procedures for the issue and transfer of shares and the holding of shareholder and board meetings.

Investment Round

- Investment round is led by one venture capital firm, firm put together a syndicate either before or after the Term Sheet is agreed and then co-ordinate the syndicate until the round is completed.
- The syndicate will usually comprise some or all of the investors and some new ones, one of whom will typically lead the round.
- Once agreed, lawyers use the Term Sheet as a basis for drafting the investment documents.

The investment process

- A venture capital investment round is usually led by one venture capital firm. That firm will put together a syndicate either before or after the Term Sheet is agreed and then co-ordinate the syndicate until the round is completed.
- The syndicate will usually comprise some or all of the existing investors and some new ones, one of whom will typically lead the round.
- There are two main sources of institutional venture capital funding for Series A investment and beyond: venture capital funds, including venture capital trusts (VCTs) and corporate strategic investors.
- Once agreed by all parties, lawyers use the Term Sheet as a basis for drafting the investment documents.
- The more detailed the Term Sheet, hopefully the fewer the issues which will need to be agreed during the drafting process.
- The process can be complex and working with lawyers who are familiar with venture capital transactions is recommended in order to minimise both timeframe and costs.

Undiluted share capital

- 'NewCo' is a company spun out from an academic institution to exploit intellectual property developed by the scientist (the founder) whilst working as an employee of that institution.
- The academic institution has agreed to transfer (assign) its ownership rights in the intellectual property rights (IPR) to NewCo in return for a 50% shareholding in the business.
- It has also agreed that the founder who has carried out the research that led to the creation of the IPR should own the other 50% through a holding of founder shares. The capital structure of NewCo is as set out below.

Start-up		
	Number of ordinary shares	Cash or cash equivalent invested at £1 per share
Founder	50	£50
Institution	50	£50
Undiluted share capital	100	

Seed Round

- NewCo then successfully attracts the investment of a venture capital company (seed investor) that specialises in investing in very early stage companies.
- The seed investor and NewCo agree that the pre-money valuation for its business is 200,000 pound.
- They agree that company needs to raise 200,0000 pound.
  - To carry out some experiments to establish the proof of principle for the technology and therefore enable it to raise its next funding round.
  - The seed investor also requires than an option pool be established that could be used to help attract new staff to join NewCo.

Seed round

	Cash or cash equivalent invested	Number of 'A' shares issued at this round	Undiluted total ordinary shares and 'A' shares	Options	Fully diluted equity	Value of shares
Founder(s)	£50	0	50	0	50	£100,000
Institution	£50	0	50	0	50	£100,000
Seed investment	£200,000	100	100	0	100	£200,000
Option pool				20	20	
Total	£200,100	100	200	20	220	£400,000

Type of Share

- Preferred class of shares: shares which certain rights attach.
  - Venture capital typically prefers since they invest more and they don't control the day to day management as compared to founders.
  - If there is a preferred share class already exists at the time of an investment round, the new round of investors will typically create a new series of preferred shares to distinguish the rights (voting, financial, etc.)
  - Distinguishing the rights enjoyed by different series is common practice because the investments made at the time of the creation of each series are usually based on different company valuations and circumstances and, consequently, have different risk profiles.

Valuation and milestones

- Investors will agree with the company on a valuation for the company prior to the new investment round (the pre-money valuation).
- This is to determine price per share to be paid by investors on the completion of the new investment round (the purchase price)
- Pre-money evaluation is 200,000 pound and prior to completion there are 100 ordinary shares. The value is 200,000/100 which equals 2000 per share.
- Fully diluted:
  - Shares issued by company
  - Shares allocated to the employee option pool
  - Other shares for options, warrants, convertible debt or other commitments.
- Post Money evaluation is the valuation of the company immediately following the new round.
  - 440000 pound = 2000 pound x (200 shares + 20 options)

Investment tranches

- Venture capital investors will not wish to make all of their investment on completion. Instead they will invest in tranches, subject to various technical and/or commercial targets (milestones) being met.
- These milestones will be set out in the Subscription Agreement.
- Failure to meet a milestone does not automatically mean that the investors will not provide the additional money, but it may mean that they will seek to negotiate different terms for these amounts.

Ratchet

- A ratchet is used to adjust the respective shareholdings of the investors and the founders depending on either the company's performance or the level of returns on an exit (exit ratchet).
- This technique is principally used to find a bridge between widely differing views of a company's value, or to provide additional incentives/rewards to the founders for delivering excellent returns to the investors.
- Ratchets can be complicated in operation and need to be very carefully thought through due to tax issues and in order to avoid conflicts of interest between the founders, the company and its other shareholders at a later date.

Dividend Rights

- Venture capital investors often invest in early stage companies that are in an intense growth phase. The objective is to grow the business and its value and to realise a return on investment (ROI), typically targeting a multiple of the amounts invested – on exit.
- In most cases such companies growing the company, rather than paying dividends to shareholders. Sometimes there is a prohibition on the payment of any dividend, which may be for a limited period of time.
- Sometimes cumulative dividend is issued to cumulate the dividend until the exit.

Liquidation preference and deemed liquidation

- The liquidation preference is a right which can be required by venture capital investors in recognition of the risk they bear on their capital contribution.
- While there are many variations, the liquidation preference typically provides that, in the event the company is liquidated or subject to a deemed liquidation, the preferred shareholders will receive a certain amount of the proceeds before any other shareholders.
- This preference amount may be equal to the amount of the preferred shareholders' investment, or a multiple of it.
- Venture capital investors usually require that the liquidation preference applies not only in connection with a liquidation or winding up of the company, but also in the case of a deemed liquidation, a term usually defined to include a merger, acquisition, change of control or consolidation of the company, or a sale of all or most of its assets, but sometimes also includes an initial public offering (IPO) or a qualified exit.

Liquidated Preference

Liquidated preference	Percentage shareholding	£200,000 liquidity event cash return	£1,000,000 liquidity event cash return
Investor	50%		
None		£100,000	£500,000
1x		£200,000	£200,000 (preference) £400,000 (share in £800,000 balance)
2x		£200,000	£400,000 (preference) £300,000 (share in £600,000 balance)
University	25%		
None		£50,000	£250,000
1x		0	£200,000
2x		0	£150,000
Founder	25%		
None		£50,000	£250,000
1x		0	£200,000
2x		0	£150,000

Redemption

- The right of redemption is the right to demand under certain conditions that the company buys back its own shares from its investors at a fixed price.
- This right may be included to require a company to buy back its shares if there has not been an exit within a pre-determined period.
- Failure to redeem shares when requested might result in the investors gaining improved rights, such as enhanced voting rights.
- A right of redemption is not appropriate for every investment and is not allowed or is limited (e.g. to a certain percentage of the issued and outstanding shares) in some jurisdictions.
- A right of redemption can also be used by an investor where it needs to strongly discourage a company from breaching certain obligations, by providing a way for the investor to dispose quickly of its shareholding.
- In jurisdictions where redemption is not possible under local company law, an alternative is to negotiate a conditional right for the investors to put (sell) their shares to the founders at a fixed price.

Conversion rights

- Where venture capital investors hold a preferred class of shares and it is permitted to convert these to ordinary shares, they generally require the right to convert them at any time, at an initial conversion ratio of 1:1.
- Conversion is normally delayed until exit so that investors are able to avoid losing the rights attached to the preferred class of shares.
- This conversion ratio will be adjusted to take account of any reorganisation of a company's capital structure.
- In some jurisdictions, this conversion ratio can be adjusted to provide for a form of anti- dilution protection.
- If a dilutive event has occurred and this ratio has been increased, the investor may choose or may be compelled to convert its preferred shares into ordinary shares immediately prior to a liquidity event (such as a trade sale or an IPO).

Automatic conversion of share class/series

- In most cases, investors will be required to convert all of their shares into ordinary shares prior to a company listing its shares on a publicly traded exchange.
- Venture capital investors often require an automatic conversion mechanism for all share classes, effective immediately prior to an IPO.
- Investors will only want this conversion mechanism to work where an IPO is likely to provide a sufficient opportunity for them to dispose of their shares (liquidity) after the expiry of any lock up periods.
- Accordingly the investors usually define certain criteria in advance that must be met for an IPO to trigger automatic conversion (usually referred to as a Qualified IPO), e.g. only offerings on certain exchanges, by recognised national underwriters, at a valuation exceeding a certain threshold and raising at least a minimum amount of gross proceeds.
- Otherwise, preferred shareholders would risk having their shares converted and losing all of their preferential rights even if the company lists its shares at a low value on a minor exchange.

Anti-dilution

- Venture capital investors often require anti-dilution protection rights to protect the value of their stake in the company, if new shares are issued at a valuation which is lower than that at which they originally invested (a down round).
- This protection usually functions by applying a mathematical formula to calculate a number of new shares which the investors will receive, for no or minimal cost, to offset the dilutive effect of the issue of cheaper shares.
- There are several variations of the formula, each providing different degrees of protection.
- These include full ratchet protection, which will maintain investors' full percentage ownership at the same level or at the same value in down rounds.
- Other versions of the formula provide some compensation for the dilution, but allow the ownership percentage to fall; the most common of these is weighted average.
- The level of protection required by an investor depends on several factors, including the valuation of the company at the time of the investment and the perceived exposure to further financing requirements.

Founder shares

- Founders and senior management are usually central to the decision of venture capital investors to put money into a company.
- Having decided to put money behind a management team they have confidence in, investors are usually keen to ensure that they remain in place to deliver their business plan.
- Therefore, it is often the case that founders and key managers (and sometimes all shareholders/employees who leave the company within a certain period of time are required to offer to sell their shares back to the company or to other shareholders.
- The price paid for the shares may depend upon circumstances of departure – it may be at market value if the founder/manager is deemed to be a good leaver, or it might be considerably less in the case of a bad leaver.
- A bad leaver may be someone who has breached his contract of employment, or it may also be someone who resigns from the company within a particular period.
- The Board often retains the right to determine whether to implement the bad leaver provisions.

Vesting

- In addition or as an alternative to good leaver/bad leaver provisions, investors may require that shares held by founders who are employees or consultants be subject to a vesting schedule in order to incentivise the founders not to leave employment with the company in the short term.
- The effect of this is that anyone holding such shares must be employed or engaged as a consultant by the company for a certain period of time if that person is to obtain unrestricted ownership of all of their shares.
- Within that period shares may vest on a straight-line basis or on whatever basis is negotiated.
- Sometimes founders have different vesting schedules in recognition of their different levels of contribution to the company.

Number of shares	0 months – 12 months	12 months – 24 months	24 months – 36 months	36 months – 48 months
Annual vesting %	12.5	12.5	12.5	12.5
Cumulative vesting %	12.5	25	37.5	50

Pre-emption rights on new share issues

- If the company makes any future share offering, a venture capital investor will require the right to maintain at least its percentage stake in the company by participating in the new offering up to the amount of its pro rata holding, under the same terms and conditions as other participating investors.
- This pre-emption right is automatically provided for by law in the UK and most Continental European jurisdictions, although it can be waived.
- If the new offering is based on a company valuation lower than that used for an investor's prior investment, that investor may also receive shares under its anti-dilution rights.
- Certain issues will usually be exempted from the pre-emption rights, including the issue of anti-dilution shares and the issue of shares on the exercise of share options.

Right of first refusal, co-sale and tag along rights

- These are contractual terms between shareholders which are usually included in the Articles of Association. If one shareholder wishes to dispose of shares that are subject to a right of first refusal (ROFR), it must first offer them to those other shareholders who have the benefit of the ROFR.
- There are usually certain exceptions to the ROFR, such as the right of individuals to transfer shares to close relatives and trusts and investors to transfer shares freely to third parties, each other or within an investor's group.
- The requirement to go through a ROFR process may add several weeks to the timescale for selling shares.
- If a shareholder wishes to dispose of shares that are the subject of a co-sale or tag along right, the other shareholders who benefit from the right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. This may have the effect of making the shares more difficult to sell.
- A venture capital investor’s decision to invest in a company is often based largely on the strength of the technical and management experience of the founders and management. It does not want these individuals to dispose of their shares in the company while it remains an investor.
- Consequently, investors frequently require a ROFR as well as co-sale/tag along rights on any sale of shares by a founder or key managers. Indeed they may sometimes require a prohibition on founders and key managers selling shares for a stated period.

Drag along and bring along

- A drag along provision (sometimes called bring along) creates an obligation on all shareholders of the company to sell their shares to a potential purchaser if a certain percentage of the shareholders (or of a specific class of shareholders) vote to sell to that purchaser.
- Often in early rounds drag along rights can only be enforced with the consent of those holding at least a majority of the shares held by investors.
- These rights can be useful in the context of a sale where potential purchasers will want to acquire 100% of the shares of the company in order to avoid having responsibilities to minority shareholders after the acquisition.
- Many jurisdictions provide for such a process, usually when a third party has acquired at least 90% of the shares (sometimes referred to as a squeeze out), but the legal process is usually subject to possible court review.
- Venture capital investors may require that certain exceptions are included in drag along provisions for situations when they cannot be obligated to sell their shares.
- Among these are drag along sales where the investors will not receive cash or marketable securities in return for their shares or will be required to provide to the purchaser representations and warranties concerning the company (or indemnify those given by the company or the founders) or covenants (such as non-compete and non-solicitation of employees).

Representations and warranties

- Venture capital investors expect appropriate representations and warranties to be provided by key founders and management and, in jurisdictions where it is allowed, the company.
- The primary purpose of the representations and warranties is to provide the investors with a complete and accurate understanding of the current condition of the company and its past history so that the investors can evaluate the risks of investing in the company prior to subscribing for its shares. The representations and warranties will typically cover areas such as the legal existence of the company (including all share capital details), the company's financial statements, the business plan, assets (in particular intellectual property rights), liabilities, material contracts, employees and litigation.
- It is very rare that a company is in a perfect state! The warrantors have the opportunity to set out issues which ought to be brought to the attention of the new investors via the disclosure letter or schedule of exceptions. This is usually provided by the warrantors and discloses detailed information concerning any exceptions to or carve-outs from the representations and warranties (e.g. specific company assets, contracts, shareholders, employees, etc.). If a matter is referred to in the disclosure letter the investors are deemed to have notice of it and will not be able to claim for breach of warranty in respect of that matter.
- Investors expect those providing representations and warranties about the company to back them up with a contractual obligation to reimburse them in the event that the representations and warranties are inaccurate or if there are exceptions to them that have not been fully disclosed. There are usually limits to the exposure of the warrantors, which are a matter for negotiation when documentation is being drawn up, and vary according to the severity of the breach, the size of the investment and the financial resources of the warrantors.

Voting rights

- Venture capital investors will have certain consent and voting rights that attach to their class of shares.
- Preferred shares may have equivalent voting rights to ordinary shares in a general meeting, though it is also possible that they may carry more than one vote per share under certain circumstances in jurisdictions where it is allowed.
- Where an appropriate event has occurred that triggers a change in the conversion ratio, the number of votes that the investors' shares will carry for any subsequent general shareholder vote will often be automatically adjusted to reflect the change in the conversion ratio at the time of the vote.

Protective provisions and consent rights (class right)

- The venture capital investors in an investment round normally require that certain actions cannot be taken by the company without the consent of the holders of a majority (or other specific percentage) of their class or series of shares (investor majority).
  - Sometimes these consent rights are split between consent of an investor majority, consent of the investor director (s) or consent of the Board.
- Typically what requires investor majority consent and what requires investor director consent would relate to major changes in the company such as those set out in the paragraph below whereas operational matters that need more urgent consideration by the Board would be left for board consent.
  - Alternatively, each of the largest investors may have specific consent rights. The purpose of these rights is to protect the investors from the company taking actions which may adversely affect the value of their investment.
- The types of actions covered include (among many others):
  - changes to share classes and share rights,
  - changes to the company's capital structure, issuance of new shares,
  - mergers and acquisitions, the sale of major assets, winding up or liquidating the company,
  - declaring dividends, incurring debts above a certain amount, appointing key members of the management team and materially changing the company's business plan.

These shareholder rights are particularly important for investors who do not appoint a director to the Board of Directors.

Board of Directors/Board Observer

- Venture capital investors require that the company has an appropriate Board of Directors
  - (note: in some Continental European jurisdictions, e.g. Germany, a two-tiered board is required: a Management Board and a Supervisory Board and in other Continental European jurisdictions where two-tiered board systems are optional, e.g. France, some investors prefer one board).
- Investors usually prefer the Board to have a majority of non-executive directors (i.e. directors who are not employees of the company). Although a majority of non-executives may be impractical for small companies, it is usual for such companies to have at least one or two non-executives. O
- ne or more of the non-executive directors will be appointed by the investors under rights granted to them in the investment documentation.
- Some investors will never appoint a director, because of potential conflicts of interest and liability issues and will instead require the right to appoint a Board Observer, who can attend all board meetings, but who will not participate in any board decisions.
- The Board of Directors tends to meet once a month in general, in particular for early stage companies with active investors on the Board.

Information rights

- In order for venture capital investors to monitor the condition of their investment, it is essential that the company provides them with certain regular updates concerning its financial condition and budgets, as well as a general right to visit the company and examine its books and records.
- This sometimes includes direct access to the company's auditors and bankers. These contractually defined obligations typically include timely transmittal of audited annual financial statements, annual budgets, and unaudited monthly and quarterly financial statements.
- However it should be noted that in some Continental European jurisdictions, a company is required to treat all shareholders equally, so that any information provided to one shareholder will have to be provided to all shareholders.

Exit

- Venture capital investors want to see a path from their investment in the company leading to an exit, most often in the form of a disposal of its shares following an IPO or by participating in a sale.
- Sometimes the threshold for a liquidity event (see paragraph 4 above) or conversion will be a qualified exit. If used, it will mean that a liquidity event will only occur and conversion of preferred shares will only be compulsory if an IPO falls within the definition of a qualified exit.
- A qualified exit is usually defined as a sale or IPO on a recognised investment exchange which in either case is of a certain value to ensure the investors get a minimum return on their investment.
- Consequently, investors usually require undertakings from the company and other shareholders that they will endeavour to achieve an appropriate share listing or trade sale within a limited period of time (typically five to seven years depending on the stage of investment and the maturity of the company).
- If such an exit is not achieved, investors often build in structures which will allow them to withdraw some or all of the amount of their investment (see paragraphs 3 and 5 above).

Registration rights

- Registration rights are a US securities law concept that is alien to many European companies and investors.
  - Such rights are needed because securities can only be offered for public sale in the US (with certain exceptions) if they have first been registered with the Securities and Exchange Commission (SEC).
  - The registration process involves the company whose shares are to be offered providing significant amounts of information about its operations and financial condition, which can be time consuming and costly.
- Unlike in European jurisdictions, where all of a company's shares usually become tradable upon a public listing, a company registering shares to be traded in the US is not required to register all of its outstanding shares.
- Any shares that are left unregistered can only be traded under very restricted circumstances, which can greatly diminish their value.
- Consequently, investors in the US or in companies which may consider pursuing a listing in the US, usually require the company to enter into a **Registration Rights Agreement**.
- Among other things, this gives the investors rights to demand registration of their shares (demand rights) and to have their shares registered along with any other shares of the company being registered (piggy-back rights) and allocates costs and potential liabilities associated with the registration process.

Confidentiality, Intellectual Property Assignment and Management, Non-compete

- It is good practice for any company to have certain types of agreements in place with its employees. For technology start-ups, this generally includes **Confidentiality Agreements** (to protect against loss of company trade secrets, know-how, customer lists, and other potentially sensitive information),

- **Intellectual Property Assignment Agreements** (to ensure that intellectual property developed by academic institutions or by employees before they were employed by the company will belong to the company) and Employment Contracts or Consultancy Agreements (which will include provisions to ensure that all intellectual property developed by a company's employees belongs to the company).

- Where the company is a spin-out from an academic institution, the founders will frequently be consultants of the company and continue to be employees of the academic institution, at least until the company is more established.

- Investors also seek to have key founders and managers enter into **Non-compete Agreements** with the company. In most cases, the investment in the company is based largely on the value of the technology and management experience of the management team and founders. If they were to leave the company to create or work for a competitor, this could significantly affect the company's value. Investors normally require that these agreements be included in the Investment Agreement as well as in the Employment/Consultancy Agreements with the founders and senior managers, to enable them to have a right of direct action against the founders and managers if the restrictions are breached.

Employee share option plan

- An employee share option plan (ESOP) is a plan that reserves and allocates a percentage of the shares of the company for share option grants to current and future employees of the company (and certain other individuals) at the discretion of a management committee.
- The intention is to provide an incentive for the employees by allowing them to share in the financial rewards resulting from the success of the company.
- Investors typically want 10%-20% of the share capital of the company to be reserved in an ESOP creating an option pool.
- The company will then be able to issue the shares under the plan without requiring further approval from the investors.
- Founders and other management with significant shareholdings may be excluded from participating in the ESOP.

Transaction and monitoring fees

- Venture capital investors are usually paid a fee by the company to cover internal and external costs incurred in connection with the investment process. In some jurisdictions this might constitute illegal financial assistance.
- Some investors may require an annual monitoring fee to compensate for the level of their involvement with the investee company, in addition to the usual compensation for travel and out-of-pocket expenses with relation to the investment management.

Confidentiality

- All exchanges of confidential information between potential venture capital investors and the company need to be subject to a Confidentiality Agreement.
- This agreement should be executed as soon as discussions with the company about a potential investment begin. If this has not been done then a confidentiality restriction should be included in the Term Sheet.

Exclusivity

- Once a Term Sheet is signed, venture capital investors will undertake various types of due diligence on the company (any or all of technical, commercial, legal and financial).
- They will usually provide the company with a list of areas which they would like to cover and information which they would like to receive.
- The process can take several weeks or even months and the investors may also use third party advisors to assist them in the process (e.g. lawyers, accountants and consultants).
- This will involve expense and the investors will not want to discover that while they are incurring this expense the company accepts investment from other investors.
- To protect themselves, some investors will ask for an exclusivity period during which the company is prohibited from seeking investment from any third parties.
- A breach of this obligation will result in the company and founders incurring a financial penalty.

Enforceability

- With the exception of clauses dealing with confidentiality, transaction fees and exclusivity, the provisions of a signed Term Sheet will not be intended to be legally binding.
- It should, however, be noted that in some Continental European jurisdictions there is an obligation to act in good faith when deciding not to proceed with an investment either at all or on the terms set out in the Term Sheet.
- If so, it might not be possible for the investors or the company to walk away from or unilaterally seek to change the Term Sheet without a justifiable reason.

Conditions precedent

- A full list of conditions to be satisfied before investment will be included in the Term Sheet.
- A venture capital investment will usually be conditional on not only the negotiation of definitive legal documents, but the satisfactory completion of due diligence and approval by the Investment Committee of each of the venture capital investors.
- Satisfactory completion of due diligence can include conclusion of commercial, scientific and intellectual property due diligence, a review of current trading and forecasts, a review of existing and proposed management service contracts, a review of the company's financial history and current financial position, either a full legal review or one targeted on specific areas and, if it is not already in place, obtaining key man insurance and satisfactory references and checks on key employees.
- It is also common for investors to require the founders and senior management to sign up to Employment or Consultancy Agreements in a form approved by the investors. In the case of investment from VCTs it will also be a condition that before they invest the appropriate tax clearance has been obtained from the Inland Revenue.

Reference

- A guide to Venture Capital Term Sheets by BVCA