the Basics of Financing the High Tech S

Securities Markets and the Internet

by Tony Stanco

THE TERM SHEET

A term sheet is used when the founders of a company intend to raise capital directly from a few investors. In this situation, the investors are typically either angels or venture capitalists (i.e., professional investors), which before the transaction are unknown or not well-known to the entrepreneurs. These private, professional investors are different from friends and family, or public investors.

Private Professional Investors are Different

With friends and family, the terms of sale of the company's stock are rudimentary and usually negotiated informally. Rather than governed by the strict terms of a contractual relationship, this type of transaction is really governed by the pre-existing close relationship of trust and confidence between the parties, and not much else. As a result, it's a possible breach of this inherent relationship of trust and confidence which leads Shakespeare in Hamlet to caution not to invest in friends because the investment "oft loses both itself and friend."

A public offering, on the other hand, is an impersonal transaction between people who never previously met and will likely never meet in the future. There are no natural ties of affection and no expectation that one group will look out for the other beyond what's imposed by the corporate and securities laws. Furthermore, in a public offering, there is no opportunity to negotiate terms. The transaction is presented on a take-it-or-leave-it basis. In theory, the underwriter is there to protect the public investors and negotiate with the company on their behalf. The purpose of the Federal securities laws and the Division of Corporation Finance at the Securities and Exchange Commission is to ensure that all the material terms of the transaction are fully and fairly disclosed in a prospectus so that, at least, investors have the basic information about the company, its management and the deal.

Professional, private investors are different. They are not friends and family that invest on the basis of a prior, close relationship with the entrepreneurs. Nor are they public investors who purchase through the impersonal markets upon reliance of the corporate and securities laws without ever meeting the business owners. These investors fall somewhere in-between. They rely on their own due diligence and contract law to protect themselves, so they meet with the founders and rigorously negotiate the transaction face-to-face.

The term sheet forms the basis for that negotiation. The negotiating points in the term sheet are haggled back and forth until agreed upon (if at all), at which point they form the basis for a formal stock purchase agreement.

Entrepreneurs at a Disadvantage

Generally, entrepreneurs are at a disadvantage in the negotiations with professional investors. First, there's the Golden Rule: "He who has the gold makes the rules." And, second, professional investors are repeat players in this game and by experience (good or bad) know how to slant the term sheet to their advantage. The good thing with professional investors, however, is that they often bring along useful business contacts and practical experience. This ultimately makes success for the entire venture more likely and an eventual IPO more probable, so that all parties may be better off in the end.

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Some Important Issues in the Term Sheet

Valuation of the Company as a Whole

Initial valuation of the company is often viewed by the founders as the most important issue. However, in reality, valuation of the whole company is only one factor in the value and risk of what the founders keep and, conversely, what they give away. The basket of all rights and obligations negotiated in the term sheet is far more important than any one item, even the company's initial valuation.

Vesting of Founders' Stock

Often a highly contentious point of discussion in the negotiations is the vesting of the founders' stock. Venture investors often request that the stock owned by the founders vest in stages. The founders will often be required to execute a vesting agreement which gives the company a right to repurchase at cost a portion of the shares held by that person in the event that employment with the company is terminated. This ensures that the founders' stake in the company increases in proportion over time to the entrepreneurs' efforts in the company.

Staged Installments by Investors

Professional investors generally only invest enough money to get the company to the next milestone. Staging their investments over time and only if predetermined milestones are met allows the investors to monitor and control thecompany as it develops. Entrepreneurs should, however, be mindful that their overly optimistic projections are often used by clever investors to set the milestones. When those milestones are not met, the entrepreneurs are in an embarrassing position with few good alternatives. Often this results in the investors ending up with a better deal than was originally anticipated by the founders, because the investors extract concessions from the entrepreneurs on the basis of the missed milestones before they agree to release the next installment.

Exit Strategies

Professional investors always have an eye to liquidating their investment at some future time. As a result they commonly insist on registration rights (demand and piggyback), co-sale rights and redemption rights.

Registration Rights

Only the company can elect to file a registration statement with the Securities and Exchange Commission to register the company's securities for pubic sale. As such, professional investors generally require registration rights so that, at some point, they can compel the company to file a registration statement so that their stock can become publicly tradable.

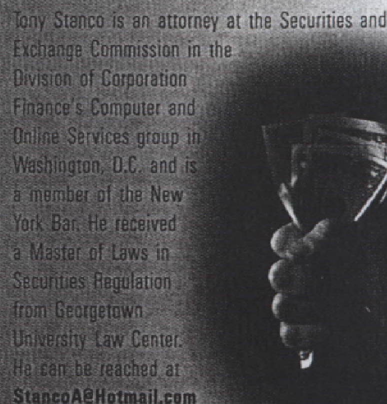
Registration rights come in two types: demand and piggyback. Demand rights provide the investors the right to demand that the company prepare, pay for and file a registration statement for the securities owned by the investor. Piggyback rights provide the right to include the securities of the venture investors in any registration statement that the company may be filing on its own initiative or for someone else. There is usually an exception in piggyback rights provisions for registration under Form S-8 employee stock benefit plans and for Form S-4 issuances used in mergers and acquisitions, since these registrations don't raise capital. To avoid embarrassment with the underwriter when the company wants to go public in the future (and to avoid costly corporate clean up work at that time), care must be exercised to ensure that the registration rights are consistent with any lock-up provisions (see, infra).

Co-Sale Rights

Co-sale rights give the professional investors the right to participate in any later sale of stock by the founders. Generally, this provision allows each investor to sell a portion of his holdings in the same percentage as what the founders are doing. This right always terminates on the company's initial public offering.

Redemption Rights

Another exit strategy for investors is to include redemption rights. Sometimes, these provisions give the investor the right to put the securities back to the company at a pre-determined time (or event) for a pre-determined price. Since the company often will not have the assets to buyout the investors at the time, these provisions are put in place to allow the investors to be in a very strong bargaining position to acquire a larger percentage, or outright control, of the company at the redemption period.



It is, however, common for the company to include the right to call the preferred stock at some date, so that it has the ability to simplify its capital structure. The company uses this right when the common stock price is substantially above the conversion price of the preferred stock, so that the call, as a practical matter, forces the holders of the preferred stock to convert their holdings into common stock, rather than to receive cash.

Lock-Ups

Underwriters usually require company insiders to abstain from selling any stock for a period of time (sometimes, up to 180 days) after the IPO to ensure that the market price does not immediately come under undue selling pressure from insider sales. In anticipation of this, professional investors in their negotiations demand that founders and any later private investors agree that they will abide by any requirement of an underwriter not to sell their securities for a certain period of time.

Convertible Preferred Stock

To provide preferences to the securities they own, venture investors generally request convertible preferred stock. The preferred stock generally provides that no dividend can be paid on the common stock unless the preferred dividend is paid. And they usually also provide that on liquidation, dissolution or winding up the holders of the preferred stock are entitled to receive an amount equal to their original purchase price plus any unpaid dividends before any disbursements are made to the common shareholders.

However, to ensure that they participate in any upside, the preferred stock is often also convertible at the option of the holder into common stock at a pre-determined, favorable rate. For corporate cleanup purposes, so that the company has an easily marketable capital structure, the preferred stock is usually automatically converted at the IPO date.

Antidilution Provisions

The convertible preferred stock owned by the investors is commonly subject to antidilution rights so that the conversion price of the stock is not adversely affected by stock splits and other events. While this right is reasonable in a number of situations, a serious problem results when the antidilution provision provides for adjustment in the event that the company issues additional shares at a lower purchase price than the professional investors originally paid. Often, in this case, the company is doing worse than expected, and to make the professional investors whole pursuant to the antidilution provisions, the company must give the investors the right to convert proportionately more stock. Obviously, this is prejudicial to the founders' ownership, since they receive no adjustment. Consequently, this innocent looking provision must be scrutinized with care to

ensure that the founders are fully aware of the consequences in the worst case scenario, which could be extremely punitive for them. It may also be advisable that the antidilution clause provide for a so-called "pay-to-play" provision, which, at least, requires that only those investors who invest further money in the company during the dilutive round of financing can take advantage of a severe "ratchet" adjustment in their conversion price.

Preemptive Rights

Investors generally want preemptive rights to ensure that they will maintain a certain percentage ownership of the company even when the company issues further securities. To ensure that the venture investors maintain this original percentage ownership in the company the preemptive rights provide that they have a pro rata right (though not an obligation) to buy securities in any subsequent equity offerings. This right, however, should exclude employee stock issuances and issuances in connection with mergers and acquisitions.

Control of the Company and Its Assets

Often, a difficult issue for founders to accept is that bringing in investors entails giving up some control and autonomy. With outside investors, the relationship between the company and the founders becomes more structured legally, and the founders' powers and freedoms are subsequently curtailed. The mechanisms used to accomplish this are shareholders agreements, employee agreements and asset assignment agreements. These agreements are generally part of, or executed concurrently with, the stock purchase agreement. The material terms, however, are usually negotiated in the term sheet.

As a general rule, investors will intrude on the management of the company in some way or another. If the company is well run, they may be less intrusive. If the company is poorly run or not making its projections, the investors often have provisions in the agreements to become much more activist and domineering.

Founders should be aware up front that it is not uncommon for founders to be terminated from "their" company and replaced with outside management when things go wrong. Furthermore, employment agreements not only usually provide for such an eventuality, but commonly also provide that the entrepreneur may not compete with the company for a reasonable time within a reasonable geographic area thereafter. Moreover, assets that are needed to run the business are generally assigned to the company at the insistence of the professional investors. These asset assignments generally include trade secrets, customer lists, patents, copyrights and trademarks. As a result, the founders are often not in a position to effectively compete with the company, even in the absence of an explicit non-compete provision in any agreements.

Non-Binding

As a technical legal matter, it should be remembered throughout the negotiations over the term sheet, and even after the term sheet is finalized and signed, that the term sheet is generally non-binding on the parties. The exception to this general rule is that provisions for confidentiality, exclusivity during the due diligence period and expenses are enforceable. All other terms are only aspirational, for the purposes of discussion only, and not intended to be binding until the definitive document, the stock purchase agreement, is drafted and executed by all the parties. Only then do all the legal rights and obligations vigorously negotiated in the term sheet become legally enforceable. ◆