Term Sheets in Venture Capital

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Synonyms

Antidilution provisions; Board control rights; Company valuation; Definitive agreements; Financial contracting; Investment terms and conditions; Investor commitment; Liquidation preference; Nonbinding agreement; Private equity; Venture capital; Voting rights

Definition/Description

A venture capital (VC) term sheet is the document outlining the conditions defining a proposed deal between an early stage company seeking financing and the VC investor supplying that capital. The term sheet provides a blueprint for the basis of the relationship between the entrepreneur and the VC investor but rarely is itself a binding legal document. In recent years, the specific elements comprising VC term sheets have become more standardized and more concise. Past research has documented that the conditions included in a term sheet can significantly impact both the start-up and exit values of the company, as well as how that value is divided between the entrepreneur and the VC investor.

Introduction

Of considerable interest to the venture capital community is the nature of the contracts formed by entrepreneurs and investors and the impact that those agreements have on financial outcomes. Sahlman (1988) observed that the goal of this contracting exercise is to decide how the interested parties divide the future risks of the deal as well as the ownership of the future cash flows it generates. Importantly, he argued that how the value of the overall enterprise is split between the suppliers and users of financial capital will be determined by these negotiations. Kaplan and Strömberg (2003) documented that VC contracts generally provide separate provisions for cash flow and company control rights, which can impact firm valuations. Cumming (2008) and Cumming and Johan (2014) showed that the control rights negotiated initially influence how the company eventually exits (i.e., by public offering or acquisition). Ewens et al. (2022) demonstrated how a variety of contract terms impact the outcome success probability for a start-up firm and how that value is shared among the parties involved.

Setting contract terms is particularly critical for new venture financing because VC investors confront informational asymmetry and illiquidity

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issues that are often acute in privately held firms. The entrepreneur and other managers of the start-up will always know more about the firm's operations, product development strategies, employee morale and incentives, sales pipeline, and expected financial performance than any prospective capital allocator. Accordingly, potential investors attempt to minimize this informational asymmetry, and the attendant possibility that they make a poor investment decision, by negotiating an equitable division of the perceived risks in the transaction based on their initial analysis. As Gordon and Orozco (2015) put it, the internal and external parties to a venture funding are in a state of "coopetition" in which these perceived risks are split according to a series of agreed-upon conditions regarding cash flow division and firm control, among other things. The VC term sheet represents the first formal step in the process that will eventually lead to a set of definitive (i.e., binding) agreements on how the transaction is funded and governed.

Term Sheets and the Due Diligence Process

The diligence process, in which VC investors gather information regarding the nature and operations of a target company, is rarely as thorough and complete as desired. Factors such as competitive pressure to complete the deal, data acquisition costs, and the lack of expertise in the company's market segment all may limit the prospective investor's ability to execute a thorough vetting process that minimizes informational asymmetry risk. Therefore, it is likely that due diligence processes will not fully resolve the uncertainties inherent in venture capital investments, which leads investors to deploy a wide variety of risk-minimizing contracting conditions in the term sheets they negotiate.

Usually, term sheets are nonbinding agreements between VC investors and the entrepreneurs seeking to raise capital. Despite that lack of legal standing, term sheets are arguably the most important documents negotiated between external investors and company management teams because they serve as an important signaling mechanism that provides information to both the venture investor and the entrepreneur about each other's primary concerns. In that way, term sheets can help assure that those worries are addressed in a manner acceptable to both parties, thereby helping to ensure a successful transaction closure.

Term sheets form the basis of the set of definitive agreements specifying the conditions that legally bind the parties in a venture capital transaction. Common definitive agreements include the Investors Rights Agreement, the Amended and Restated Certificate of Incorporation, the Right of First Refusal and Co-Sale Agreement, and the Stock Purchase Agreement and Voting Agreement. The term sheet, therefore, can be viewed as a summary of the conditions that ultimately will be developed more completely in the collection of definitive agreements.

In nearly all cases, the conditions negotiated in a term sheet protect investors against potential losses after a deal has closed by: (i) requiring the entrepreneur to furnish periodic financial and operational reports (i.e., information rights); (ii) giving investors the ability to influence corporate decision-making and provide management incentives (i.e., governance rights); and (iii) determining the allocation of economic benefits and incentives among investors and the company (i.e., economic rights). Without those downside protections, investors would bear appreciably more risk and be much less likely to invest in private market securities without demanding significantly lower valuations.

Term Sheets: Organization and Elements

As Wilmerding (2006) and Smeele (2014) noted, term sheets can take on many different forms, but there are several critical elements they are all likely to contain. In recent years, there has been a trend to standardize and simplify the way term sheets are organized to the point where they can often be expressed on a few pages. Figure 1

Company:	[__________], a Delaware corporation.
Securities:	Series A Preferred Stock of the Company (“**Series A**”).
Investment Amounts:	$[_] million from [__________] (“**Lead Investor**”) $[_] million from other investors Convertible notes and safes (“**Convertibles**”) convert on their terms into shadow series of preferred stock (together with the Series A, the “**Preferred Stock**”).
Valuation:	$[_] million **<u>post-money</u>** valuation, including an available option pool equal to [__]% of the post-Closing fully-diluted capitalization.
Liquidation Preference:	1x non-participating preference. A sale of all or substantially all of the Company’s assets, or a merger (collectively, a “**Company Sale**”), will be treated as a liquidation.
Dividends:	6% noncumulative, payable if and when declared by the Board of Directors.
Conversion to Common Stock:	At holder’s option and automatically on (i) IPO or (ii) approval of a majority of Preferred Stock (on an as-converted basis) (the “**Preferred Majority**”). Conversion ratio initially 1-to-1, subject to standard adjustments.
Voting Rights:	Approval of the Preferred Majority required to (i) change rights, preferences or privileges of the Preferred Stock; (ii) change the authorized number of shares; (iii) create securities senior or pari passu to the existing Preferred Stock; (iv) redeem or repurchase any shares (except for purchases at cost upon termination of services or exercises of contractual rights of first refusal); (v) declare or pay any dividend; (vi) change the authorized number of directors; or (vii) liquidate or dissolve, including a Company Sale. Otherwise votes with Common Stock on an as-converted basis.
Drag-Along:	Founders, investors and 1% stockholders required to vote for a Company Sale approved by (i) the Board, (ii) the Preferred Majority and (iii) a majority of Common Stock [(excluding shares of Common Stock issuable or issued upon conversion of the Preferred Stock)] (the “**Common Majority**”), subject to standard exceptions.
Other Rights & Matters:	The Preferred Stock will have standard broad-based weighted average anti-dilution rights, first refusal and co-sale rights over founder stock transfers, registration rights, pro rata rights and information rights. Company counsel drafts documents. Company pays Lead Investor’s legal fees, capped at $30,000.
Board:	[Lead Investor designates 1 director. Common Majority designates 2 directors.]
Founder and Employee Vesting:	Founders: [_______________]. Employees: 4-year monthly vesting with 1-year cliff.
No Shop:	For 30 days, the Company will not solicit, encourage or accept any offers for the acquisition of Company capital stock (other than equity compensation for service providers), or of all or any substantial portion of Company assets.

The “No Shop” is legally binding between the parties. Everything else in this term sheet is non-binding and only intended to be a summary of the proposed terms of this financing.

[COMPANY]

By: ______________________________

Name: ______________________________

Title: ______________________________

Date: ______________________________

[LEAD INVESTOR]

By: ______________________________

Name: ______________________________

Title: ______________________________

Date: ______________________________

Term Sheets in Venture Capital, Fig. 1 Template for a VC Series A term sheet. (© Y Combinator Management, LLC, 2023) illustrates a template for this concise approach to representing a VC term sheet, as shown in Kwon and Harris (2023) of Y Combinator, a VC start-up accelerator firm. Other term sheet examples are furnished by the National Venture Capital Association (2022), a nonprofit organization promoting research and advocacy efforts for the VC industry, and MaRS (2023), a Canadian VC start-up facilitator.

The following provides a general discussion of how term sheets are organized, the key components that they contain, and the rationale for including those provisions. These elements are separated into (1) investment provisions, (2) corporate control provisions, and (3) other key terms, which align with the primary concerns of the deal participants that these documents are intended to address.

Investment Provisions

Term sheets set forth the proposed economic parameters of the transaction, which specify the following: the deal price and how it will be paid, the types of securities involved, the postclosing ownership structure, any preconditions to completing the deal, and other important features of the transaction. The proposed structure of the transaction includes, in its most basic form, the amount of capital to be committed by the VC investor, when it will be invested, and the types of securities that will be issued by the company.

Securities

There are four types of securities that are typically issued by early stage companies: common stock, preferred stock, convertible notes, and simple agreements for future equity ("SAFE").

Common stockholders are residual claimants on the company's cash flow and are subordinated to government claims, taxes, pensions and other regulated employee claims, accounts payable, debt payments, and preferred stock. VC investors typically prefer not to invest as common stockholders, opting instead for ownership forms that provide more downside protection, may accrue dividends, and can include a stronger set of control provisions regarding the company's operations and governance structure.

Two types of preferred stock are often employed in VC transactions: convertible preferred and participating convertible preferred. Convertible preferred stock, which can be exchanged into common stock at the shareholder's option, gives investors both downside protection and potential upside participation as the firm's value increases. The downside protection comes in the form of a payment, usually equal to the amount initially invested plus any accrued dividends, that the investor can elect to receive in cash or exchange into common shares upon a successful sale of the company. By contrast, participating convertible preferred shareholders do not have to choose whether to make this conversion because they receive this payment automatically as well as their proportion of sale proceeds above the payment. In the event of an initial public offering (IPO), preferred shares are automatically converted to common shares with no additional payment.

SAFE securities are another form of convertible agreement that allows VC investors to convert their capital commitments into equity securities at a discounted price in a future financing round. SAFE agreements, unlike convertible notes, do not have maturity dates and do not pay interest. In recent years, they have been used more frequently by very early stage companies for which determining an accurate valuation is difficult.

Liquidation Preferences

A liquidation preference defines the order in which the proceeds from the sale or liquidation of the company are distributed among its stakeholders. As such, these provisions serve as an important protective measure for VC investors. Preferred stockholders, such as venture capitalists, are typically granted a specific liquidation preference that ensures they receive a certain multiple of their initial investment before common stockholders receive any proceeds. As noted, this preference provides a form of downside protection for investors, mitigating the risk of losing their principal in the event of a less-than-optimal exit for the start-up firm.

The liquidation preference is often expressed as a multiple of the original investment, such as 1x or 2x, and it significantly influences the distribution of returns among different classes of shareholders. In situations where the exit value of the start-up is below the total investment, the liquidation preference becomes particularly significant, as it helps investors recoup their capital before other shareholders (e.g., entrepreneurs) participate in the distribution. For that reason, this provision is usually one of the most hotly negotiated terms between the participants to a potential VC transaction.

Antidilution Provisions

Antidilution provisions, or ratchets, are intended to protect VC investors against share price declines that occur during subsequent fundraising rounds or an IPO event. In later fundings, a ratchet is triggered in a down round, which occurs if the stock price at which the company raises capital is less than the price in the round containing the ratchet provision. Brown and Wiles (2016) described the "toxic" (i.e., value destroying) effect these provisions can sometimes have when multiple funding rounds make the terms and conditions applicable to various investors increasingly opaque.

If a ratchet is triggered by a down round of financing, the ratio at which the preferred stock is converted into common is adjusted to reflect the new price, either on a full basis or on a weighted average basis. Under a full ratchet, the price of the shares with protection is essentially reduced (i.e., "reset") to the current lower price. Under a weighted average ratchet, the price is adjusted to an average of the two prices, weighted by the amount of capital raised in each round. Hess et al. (2023) documented that over a recent 2-year period, about 35% of venture capital funding rounds contained ratchets, with all of them being of the weighted average variety.

Option Pool Shares and Repurchase Rights

Two other term sheet provisions that impact the allocation of shares among investors, founders, and management are (1) the determination of how option shares are allocated, and (2) the company's right to repurchase shares from management.

The shares allocated to an option pool, which is intended to incentivize employees by allowing them to participate in firm value increases, are furnished by the company either before or after the new investment round is closed. The impact of this timing can be significant. If the pool is established with preclosing shares, existing shareholders will see their ownership interest diluted, but new investors will not. Alternatively, if the new capital round is closed before the option pool is established, all shareholders will be diluted proportionally.

Term sheets can also include provisions allowing the company to repurchase the shares held by a founder or an employee when that person leaves the company. If removed for cause, the company can generally repurchase the employee's shares at cost. If terminated without cause, the company can often repurchase the employee's shares at market value. Finally, if an employee leaves voluntarily, the company usually can repurchase any unvested shares at cost and vested shares at market value. The definitions of with and without cause, as well as how market value is established, are specified in the employment agreements and the definitive agreements.

Pay-to-Play

Pay-to-play provisions require investors to participate, in accordance with their pro rata ownership percentage, in any future company fundraising, including any down rounds initiated by the firm. If an investor does not reinvest in accordance with a play-to-play provision, their existing preferred stock position may be converted to common stock or may be stripped of other key provisions and protections, such as preference payments, ratchets, and board seat designations.

Corporate Control Provisions

Term sheets should also address several issues related to the governance structure of the company, including:

Stock Voting Rights

The term sheet should delineate the extent of the investor's voting rights with respect to matters such as changes in the authorized number of shares, creation of senior security classes, redemption or repurchase of shares, distribution of assets and dividend payments, or the sale or liquidation of the company. Generally, common stockholders receive voting rights in proportion to the number of shares held while preferred stockholders must be granted protective voting rights in the term sheet and definitive agreements.

Board of Directors Matters

Preferred stock has no voting rights except as set forth in the definitive agreements. Therefore, any board seats held by preferred stock investors must be specified in the term sheet and, ultimately, in the definitive agreements. The term sheet will also establish the frequency of board meetings, any board observation rights conveyed, how special board meetings may be called, and how information and notices will be provided by the company to the board.

Information Rights

These stipulations specify the terms required of the management to periodically report details of the company's operations and financial condition. This stipulation often is included to ensure that VC investors receive the data and analysis necessary to properly monitor the start-up firm.

Management Rights

These conditions give the investor the ability to participate in the management of the company, under certain conditions. These rights can include such actions as advising company management or attending board meetings.

Founder and Employee Vesting

The founders and key employees of a start-up often own shares in the company as soon as they make an initial investment. However, a vesting obligation can be imposed to require that share ownership be earned over time. Term sheets may include specific language delineating the VC investor's expectations about the process and the schedule by which founder shares will become vested.

Drag-Along Rights

This stipulation requires a stockholder to vote to approve a transaction involving the company that has already been approved by a certain percentage of the other stockholders or by the board. Term sheets usually include drag-along provisions to enable majority shareholders (e.g., the VC investor) to compel a minority shareholder (e.g., a founding entrepreneur) to commit to the sale of the company on the same terms as all other investors.

Other Key Terms

Term sheets may also specify a variety of other key terms and conditions. A list of the most frequently used provisions includes the following:

- *Expenses:* Term sheets typically require the company to pay for the VC investor's legal fees up to a specific amount.
- *Indemnifications:* These are terms that define how one party to a transaction makes another party whole for any liability, damage, or loss incurred by the second party because of actions taken, or not taken, by the first party. Investors might, for example, be required to compensate a company if they release publicly proprietary information covered by a nondisclosure agreement.
- *Lock-Up Provisions:* These stipulations require investors to refrain from selling their stock, if specifically requested by an investment banking firm underwriting the company's IPO. Lock-up provisions often remain in force for up to 180 days following the IPO completion.
- *Mandatory Conversion:* Automatically converts preferred shares into common shares upon the successful completion of a qualified IPO.
- *No-Shop:* Upon execution of the term sheet, investors will usually require that the company cease any actions to seek, and refrain from accepting, financing from other parties or to pursue the sale of the company by other means.
- *Representations and Warranties:* A representation is a statement of fact understood to be true at the time the transaction closes and a warranty specifies how each party will

compensate the other if a representation proves to be false. A common representation is that each party has received all necessary approvals to close the transaction.
- *Right of First Refusal:* Provisions that grant investors the right to participate in any future fundraising rounds up to their pro rata ownership percentage.
- *Various Registration Rights:* These conditions specify how and when VC investors may require the company to pursue an IPO or otherwise permit the registered sale of their stock holdings.

Concluding Thoughts

Term sheets serve as an important signaling mechanism that provides information to VC investors and entrepreneurs about their respective primary concerns. These documents can help ensure that those concerns are addressed in a way that is acceptable to both parties and thereby permit them to close the transaction successfully. Term sheets also form the basis for the definitive agreements that specify the formal provisions and conditions that legally bind the company and the investors.

Venture capital investment firms are an important component of the capital markets because they provide the investment funds and expertise to help entrepreneurs grow their companies. VC investors are also experts at negotiating term sheets, whereas entrepreneurs, who access the capital markets only infrequently, usually are not. Of course, there will always be significant pressure on entrepreneurs to raise funds, even with restrictive terms that favor the VC investor, because they need the capital to operate their companies.

Cross-References

▶ Contracting in Venture Capital
▶ Fundraising in Venture Capital
▶ Venture Capital and Corporate Governance of Entrepreneurial Ventures

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