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Guide to Negotiating a Venture Capital Round

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Introduction

One of the most significant events in a startup company's life cycle is raising its first round of venture capital. Up to that point, most companies have survived by "bootstrapping it" with perhaps some help from friends and family and maybe an angel investor or two. These earlier rounds of financing are usually relatively simplistic and don't involve overly complex securities or intense negotiations with the investors. However, when a startup enters the venture world, all of this changes dramatically: complexity and intense negotiation are the norm, and startups are now faced, for the first time, with concepts such as participating preferred stock, conversion rights, anti-dilution, and a whole host of other fairly new and complex topics.

In this guide, we'll explain many of the key concepts that arise in a typical venture capital (VC) transaction. Our goal will be to explain these concepts to those startups who are newcomers to the venture world. To do this, we'll walk you through the National Venture Capital Association's (NVCA) term sheet and provide some commentary that we hope will be helpful. As you read this guide, you should make reference to the NVCA term sheet, which can be found on the NVCA's website under "Model Legal Documents."

Many startups find themselves in the unenviable position of being at the mercy of a single venture capital source as they seek financing without having a tentative agreement on some basic terms. All too often it seems the startup is so eager or desperate to find financing that it locks in on a single VC firm and ends up with very little leverage when it comes time to negotiate the deal. The end result is often unfavorable terms or perhaps terms that are not as fair as could have been obtained. To prevent this result, it's prudent to avoid, if possible, limiting your options to a single VC firm until you've agreed on many of the tentative deal terms that will be set forth in a term sheet. Or even better, if your startup is lucky enough to have multiple potential financing sources, it may be wise to get a signed term sheet before focusing on one source.

Binding vs. Non-Binding Provisions

It's very important to note which portions of the term sheet are binding and which are not. The preamble to the NVCA model term sheet sets out the "No Shop/Confidentiality" provisions as binding and lists the "Counsel and Expenses" provisions in brackets indicating that sometimes they may be binding and sometimes they may not. We'll get into the substance of these provisions later. Our purpose now is simply to illustrate that some provisions in the term sheet constitute a binding legal contract while others do not. Importantly, the NVCA model term sheet makes clear that it does not constitute a legal commitment by the VC firm to make any investment in the startup. Therefore, startups should recognize that execution of a term sheet, while a key milestone towards receiving funding, is mostly non-binding on the VC firm and is certainly not an assurance that any such transaction/financing will actually close.

Second, in some jurisdictions a term sheet that expressly states that it is non-binding may nonetheless create an enforceable obligation to negotiate the terms set forth in the term sheet in good faith. A startup that for some reason thinks it can get out of a deal after the term sheet is signed (perhaps if it comes into a better offer) should realize that good faith negotiations may be required and that simply pulling out of the deal may result in legal liability.

Valuation, Capitalization Tables, and Price per Share

Valuation in the context of a venture capital transaction can be expressed in terms of pre-money valuation or post-money valuation. Pre-money valuation refers to the valuation of the company prior to the investment, whereas post-money valuation refers to the value after an investment has been made. Most founders, when they think of the concept of valuation, are referring to pre-money valuation. Calculating pre-money valuation is not intuitive or straightforward. When most people talk about a venture capital investment, usually the investor will say "I'll give you $1.2 million for 10% of the company." What is the implied pre-money valuation in this example? You might think the answer is $12 million, but that is actually the post-money valuation, not the pre-money valuation. To get the pre-money valuation, you need to first calculate post-money valuation and then back into the pre-money valuation.

Post-money valuation is pretty straightforward to calculate. You take the dollar amount of the investment and divide it by the percent that the investor is getting. In our example above, $1.2 million is divided by 10%, yielding a post-money valuation of $12 million. But prior to the $1.2 million investment, the company is not worth $12 million. This is because once you add $1.2 million worth of cash on to the company's balance sheet the company has just increased in value by $1.2 million. Therefore, to calculate pre-money valuation, you need to take a second step, which is to subtract the amount of investment from the post-money valuation. In the example above, the company is being valued at $10.8 million. This is calculated by taking the $12 million post-money valuation and subtracting the amount of the investment ($1.2 million).

Once we calculate the valuation, we need to figure out how many shares the investor gets for its investment and this is determined using a capitalization table. This also is not always as straightforward as you might think, because there may be holders of options or warrants in the company, and there may be an employee stock pool as well. So if the founders have 4.5 million shares of the company, they might think that giving the investor 10% in the company involves the company issuing 500,000 shares to the investor. But venture capital firms often consider more than just the shares issued to founders and previous investors. They will often also include, in the capitalization table, the employee stock pool and any outstanding warrants. This is what is referred to as the fully diluted post-money capitalization. In our sample capitalization table below, you can see that the company must issue more than 500,000 shares to give our potential venture capital investor 10% in the company.

Pre and Post-Financing Capitalization

	Pre-Financing		**Post-Financing**	
Security	**# of Shares**	**%**	**# of Shares**	**%**
Common – Founders	4,500,000	83.33%	4,500,000	75%
Common – Employee Stock Pool (Issued)	0	0%	0	0%
Common – Employee Stock Pool (Not issued)	900,000	16.67%	900,000	15%
Common – Warrants	0	0%	0	0%
Series A Preferred	0	0%	600,000	10%
Total	5,400,000	100%	6,000,000	100%

Because even the unissued employee stock is considered in the fully diluted post-money capitalization, in order to give the investor 10% of the company, 600,000 shares ("Series A Preferred") must be issued.

Finally, we need to calculate the per share price. Once you know how many shares the company will be issuing to the investor, just divide the amount of the investment by the number of shares issued. In the example above, the share price would be $2 per share, calculated by dividing the investment amount ($1.2 million) by the number of shares issued (600,000).

Dividends

Dividends are one of the rights that often make preferred stock "preferred" (relative to common). In short, dividends increase the total return to the preferred stockholders and decrease the total return to the common stockholders. Dividends are often stated as a percentage of the original issue price for the preferred stock (e.g., a dividend may be stated as 5.0% of the "Series A Original Issue Price"; the original issue price is simply the price paid for the stock by the preferred investors). There are at least three common ways dividends are structured in venture capital deals:

- Cumulative dividends
- Non-cumulative dividends
- Dividends on preferred stock only when paid on the common stock

Cumulative dividends are the most beneficial to the preferred stockholders and the most burdensome on the common stockholders. Cumulative dividends accrue on the original issue price and are typically paid on liquidation of the startup or upon redemption of the preferred stock (most startups do not have funds to pay dividends currently, so that's the reason for payment upon liquidation or redemption). The accruing dividends represent a future obligation of the startup to the preferred stockholders, which reduces funds available for common stockholders. Cumulative dividends may be structured on a simple basis, where the accruing dividend is calculated on the original issue price but not on any previous accrued and unpaid dividends, or on a compound basis, where all prior accrued and unpaid dividends are taken into account in determining future dividends (the same concept as simple versus compound interest).

Non-cumulative dividends, on the other hand, are paid on the preferred stock only if the board of directors declares them; if they are not paid, they do not accrue and do not result in a future obligation to the preferred stockholders. So you may have an 8.0% dividend preference for the preferred stock; however, if the board of directors does not declare the dividend, then it's forfeited. This is a significantly better structure for the common stockholders.

The third common method of structuring dividends in a venture deal is to have a dividend paid on the preferred only if paid on the common. In this scenario, the preferred is treated as if it had been converted into common at the time the dividend is declared and the preferred and common stock share in the dividend as if all shares were converted to common.

This is the least beneficial to the preferred stock (this structure does not result in a dividend preference to the preferred stock at all) and the most beneficial to the common stock.

The NVCA model term sheet has a sample term sheet containing these three options. You should understand the various ways dividends can be structured and consider (i) the likelihood that cash flow will be available to pay dividends currently (as opposed to upon liquidation, for example) and (ii) the dividend structure's impact on the total return to the preferred stockholders and the diminution in total return to the common stockholders. Cumulative dividends can particularly affect the returns if the holding period is relatively long (and this is even more true if the unpaid dividends are compounded).

"As Converted"

When reviewing the NVCA model legal documents, you'll notice use of the phrase "on an as-converted basis" in several areas. For example, the NVCA model term sheet section on dividends provides under Alternative 1 that dividends will be paid on the preferred stock "on an as converted basis when, as, and if paid on the common." Similarly, under the discussion of voting rights, the NVCA model term sheet provides that the preferred stock votes together with the common "on an as-converted basis."

This "as converted basis" concept means that, when determining the right or benefit of preferred stock, it is assumed that the preferred stock has been converted into some number of common shares. To determine the number of common shares into which the preferred shares are deemed to convert, you simply multiply the number of shares of preferred stock in question by the conversion ratio. The conversion ratio is the price paid for the shares of preferred stock (referred to as the "Series A Original Issue Price") divided by the then-current conversion price. Initially, the conversion price is usually set to equal the Series A Original Issue Price so that the initial conversion ratio is 1:1.

As an example, assume 25,000 shares of Series A Preferred stock is initially purchased for $10 per share and has a $10 per share Series A Conversion Price so that the initial conversion ratio is 1:1. If there have been no adjustments to the Series A Conversion Price after the issuance of the Series A, then 25,000 shares of Series A Preferred will be deemed to convert into 25,000 shares of common stock for purposes of determining the rights or benefits of the preferred stock (e.g., voting rights).

However, if there have been diluting events, the conversion price may have been adjusted downward under the anti-dilution provisions (discussed below). If we assume a conversion price of $8 per share due to dilution adjustments, the new conversion ratio would be 1.25, which equals $10 (the Series A Original Issue Price) / $8 (the current Series A Conversion Price). This means our 25,000 shares of Series A Preferred would be deemed to convert into 31,250 shares of common stock for purposes of determining the rights or benefits of the preferred stock (again, if we are determining voting rights, for example, this will mean the 25,000 shares of preferred stock receive 31,250 votes).

Optional and Mandatory Conversion

The "as converted" concept is fictional in the sense that the preferred shares have not actually been converted. Instead, we are assuming conversion simply to calculate the quantity of votes or dividends or some other right of the preferred stock.

However, the preferred stock may convert into common stock upon certain events. As noted in the NVCA model term sheet, there is a section called "Optional Conversion" which simply states that preferred stock may be converted into common stock at any time at the option of the stockholder and notes the initial 1:1 conversion ratio.

Why would a stockholder convert his or her shares from preferred to common? Depending on the structure and economics of the deal, the stockholder may receive more cash upon liquidation if the shares are converted into common stock. For example, a common structure on liquidation might be for the preferred stockholder to either (i) receive a liquidation preference equal to return of its initial investment (or some multiple thereof) or (ii) convert to common and give up the liquidation preference (i.e., a non-participating preferred structure, which we discussed earlier). If the sale price is high enough, the stockholder will receive more by giving up its liquidation preference and participating as a common stockholder. This is described in more detail below in the section called "Liquidation Preference."

The NVCA model term sheet also provides for mandatory conversion upon an initial public offering, provided certain minimum thresholds are achieved, or upon written consent of the holders of Series A preferred stock. In the model term sheet, the minimum thresholds for conversion upon an IPO are that the IPO stock be sold for some minimum multiple of the initial preferred purchase price and that the company receives some minimum amount of proceeds. These thresholds provide some assurance to the holders of preferred stock that they will receive a reasonable return before being forced to convert their shares to common stock.

In negotiating the mandatory conversion provisions of the term sheet, founders should press for a relatively low multiple of the original purchase price (perhaps 2x to 3x) and total proceeds required to be received to minimize disruption of an IPO by the preferred stockholders.

Liquidation Preferences

The liquidation preference is essentially what makes preferred stock "preferred." It is the most important economic provision in a venture capital financing transaction other than the valuation. The liquidation preference provisions govern how the proceeds will be distributed to stockholders when and if the company is actually liquidated or is sold in an M&A transaction (called a "deemed liquidation"). Stockholders with a liquidation preference receive the proceeds of liquidation or deemed liquidation before the common stockholders, and may, depending on the exact terms of the liquidation preference, receive a percentage of the proceeds that is greater than their percentage ownership of the company (resulting in other stockholders receiving a percentage of the proceeds that is less than their percentage ownership). The liquidation preference does not come into play if the company goes public, as the preferred stock issued to investors converts to common stock and the liquidation preference goes away.

The amount of a liquidation preference can vary, but is usually linked to the purchase price of the stock itself. For instance, if a VC buys the preferred stock for $1 per share, then the liquidation preference will be equal to $1 per share. This is known as a 1x liquidation preference. However, liquidation preferences can be equal to multiples of the purchase price, resulting in 2x, 3x, or higher liquidation preferences. They can also be combined with preferred dividends. For example, a VC term sheet could provide for a 2x liquidation preference plus an 8% cumulative non-compounding preferred return. After three years, the liquidation preference would be 224% of the original purchase price (2x the purchase price plus three 8% returns). High liquidation preferences combined with preferred dividends can easily wipe away any economic reward for the common stockholders, so it's important for a startup not to give away too much in this area.

There are two basic types of liquidation preference provisions: participating preferred and non-participating preferred. Holders of participating preferred stock receive the liquidation preference applicable to those shares and also receive a portion of the proceeds after all liquidation preferences have been paid out as if they had converted their preferred stock to common stock. Holders of non-participating preferred stock receive only the liquidation preference and cannot "participate" as common stockholders. However, since preferred stockholders can usually convert their shares to common stock at any time, in practice, this means that holders of non-participating preferred stock receive the greater of their liquidation preference or what they would have received if they were common stockholders. Participating preferred stockholders receive more than their percentage ownership of the company on an as-converted-to-common-stock basis (and consequently cause common stockholders to receive less); whereas, with non-participating preferred stock, the liquidation preference will become meaningless if the company sells for a high enough amount.

Founders prefer that investors receive non-participating preferred stock while investors prefer to receive participating preferred stock. This point can be particularly contentious in a term sheet negotiation. One potential compromise is to issue participating preferred stock subject to a cap on participation. A cap on participation limits the amount received by the preferred stockholders to a fixed amount. The cap is often set as a multiple of the original investment amount, such as 2x or 3x. Once the preferred stockholders have received the cap amount, they stop participating in distributions with the common stockholders. Consequently, if the exit event amount is high enough, the holders of preferred stock would be better off converting them to common stock, similar to the way they would be if they held non-participating preferred stock with a liquidation multiple.

Let's take a look at an example. Let's say that a venture capital fund takes a 20% interest in Company X for \$2.0 million (an \$8.0 million pre-money and \$10.0 million post-money valuation). The price is \$1 per share with a 1x liquidation presence and no preferred dividends. Assuming there are 8 million common shares outstanding, the VC would receive 2 million preferred shares.

Let's say Company X is sold a few years later for net proceeds of \$30 million. The results would be the following upon liquidation:

	If Preferred Stock is Participating Preferred	**If Preferred Stock is Non-participating Preferred**
Preferred Stockholders	\$7.6 million (25.33%)	\$6 million (20%)
Common Stockholders	\$22.4 million (74.67%)	\$24 million (80%)

In an alternative scenario, if Company X sold for a disappointing $3 million, the results would be the following:

	If Preferred Stock is Participating Preferred	If Preferred Stock is Non-participating Preferred
Preferred Stockholders	$2.2 million (73.33%)	$2 million (66.67%)
Common Stockholders	$0.8 million (26.67%)	$1 million (33.33%)

In each of the above examples, if the VC has participating preferred stock, it has no reason to convert its stock to common stock because the preferred stock is able to receive proceeds as if it is a common stockholder as well as what it would receive as a preferred stockholder. But if the VC has non-participating preferred stock, the calculus change. In the first example, if the VC doesn't convert, it receives $2 million (the liquidation preference) and if it does, it receives $6 million (20% of all proceeds). Thus, the VC likely converts. In the second example, if the VC doesn't' convert, it receives $2 million (the liquidation preference) and, if it does, it receives $600,000 (20% of all proceeds). Thus, the VC likely doesn't convert.

As you can see, how a liquidation preference is structured can make a big difference when the proceeds of a sale of the company are divvied up. Therefore, founders should pay particular attention to this provision when negotiating term sheets.

Voting Rights

Delaware corporate law, by default, requires any amendment to a corporation's certificate of incorporation receive the approval of the holders of a majority of each class of stock. The NVCA model legal documents override this, and provide that generally all classes of stock vote together as a single class on an as-converted basis. The most important application of this is that no separate approval of the preferred stockholders or common stockholders is necessary to approve an increase in the number of authorized common shares as long as a majority of all stockholders approve the change. However, venture capital investors typically require that they have the power to elect a certain number of seats on the company's board of directors. The number of board seats is typically a matter of negotiation and depends on the overall size of the board as well as the size of the investment being made.

Protective Provisions

In addition to the right to appoint a certain number of board seats, investors in venture capital deals often secure other rights that protect them from changes being made that could potentially harm them or reduce the value of their investment. These provisions typically require that a certain percentage (often a majority, but sometimes a supermajority) of the preferred stockholders vote to approve certain actions. The actions typically included are:

- dissolving the company;
- making any changes to the certificate of incorporation or bylaws that adversely affect the preferred stockholders;
- authorizing or issuing new stock on parity with or senior to the preferred stock;
- purchasing or redeeming any stock prior to the preferred stock;
- taking on debt;
- engaging in certain transactions involving subsidiaries of the company; and
- changing the size of the board.

In addition, you will also typically find provisions that require the vote of one or more of the directors appointed by the investors in order for the board to take any of the following actions:

- selling significant assets of the company;
- making any investments (either debt or equity) in any other companies;
- extending any loans to any persons, including employees and directors;
- guaranteeing any debt;
- making investment decisions inconsistent with approved policies;
- incurring indebtedness in excess of a certain amount other than in the ordinary course of business;
- entering into any other transactions with any director, officer, or employee;
- hiring, firing, or changing the compensation of executive officers;
- changing the principal business of the company;
- selling, assigning, licensing, or using as collateral to a loan any of the company's material intellectual property, other than in the ordinary course of business; and
- entering into any strategic relationship involving any payment or contribution in excess of a certain amount.

The protective provisions are often overlooked by founders when they negotiate term sheets, perhaps with the exception of the number of board seats the investors are getting. Since they don't impact the economics of the deal in any direct way, they are often deemed unimportant. Most of the protective provisions involve company decision-making in one way or another and at least initially, the founders typically envision involving their investors in major decision-making. Early on, it would usually be unthinkable for the company to take a major action that its largest investor opposes. However, after a number of investment rounds, there could be any number of potential vetoes of company actions and the governance process may become unwieldy. Some of the protective provisions, such as a requirement to obtain the investor-appointed director's approval for any strategic relationship involving a payment or contribution in excess of $X, may give one particular investor too much ability to veto new opportunities for the company that were not envisioned early in its life.

In addition, founders should pay attention to how the protective provisions interact when there have been multiple rounds of financing. For instance, if there have been five rounds (e.g., Series A, B, C, D, and E), it would probably not be appropriate to require a director appointed by each series to approve every license of material intellectual property. Therefore, when a company takes on a new investment round, the company's management should look at making appropriate changes to the previous round's investor's protective provisions. Often, the new investor can be helpful in this process by making such changes a condition to closing the new round.

Anti-dilution Provisions

What is Dilution?

Dilution refers to the phenomenon of a stockholder's ownership percentage in a company decreasing because of an increase in the number of outstanding shares, leaving the stockholder with a smaller piece of the corporate pie. The total number of outstanding shares can increase for any number of reasons, such as the issuance of new shares to raise equity capital or the exercise of stock options or warrants.

However, not all dilutive issuances are harmful to the existing stockholders. If the company issues shares but receives sufficient cash in exchange for the shares, the stockholders' ownership percentages may be reduced but the value of the company has increased enough to offset the lower ownership percentage. On the other hand, if the cash received is insufficient, the increase in the value of the company will not be enough to offset the reduction in ownership percentages.

In venture capital deals, the transaction documents typically include negotiated provisions designed to deal with a dilutive issuance that would otherwise reduce the value of the preferred investors' shares (relative to the price the preferred investors paid for their shares). These provisions are referred to as "anti-dilution provisions."

Anti-dilution Provisions

In venture capital terms, dilution becomes a concern for preferred stockholders when confronted with a "down round" — a later issuance of stock at a price that is lower than the preferred issue price. Anti-dilution provisions protect against a down round by adjusting the price at which the preferred stock converts into common stock. Many of the preferences of the preferred stock are based on the number of shares of common stock into which the preferred stock converts (e.g., voting rights, dividend rights, and liquidation preferences).

There are three common alternatives for anti-dilution provisions described in the NVCA model term sheet: full ratchet, weighted average, and no price-based anti-dilution protection.

Full Ratchet

A "full ratchet" provision is the simplest type of anti-dilution provision, but it is the most burdensome on the common stockholders and it can have significant negative effects on later stock issuances. Full ratchet works by simply reducing the conversion price of the existing preferred to the price at which new shares are issued in a later round. So if the preferred investor bought in at $1.00 per share and a down round later occurs in which stock is issued at $0.50 per share, the preferred investor's conversion price will convert to $0.50 per share. This means each preferred share now converts into 2 common shares.

Full ratchet is easy and it's the most advantageous way to handle dilution from the preferred investor's standpoint, but it is the most risky for the holders of any common stock. With this approach, the common stockholders bear all of the downside risk while both common and preferred share in the upside.

Full ratchet can also make later rounds more difficult. If the company needs to issue a Series B round and the stock price has decreased, it may be difficult to get the Series A investors to participate because they are getting a full conversion price adjustment. In essence, the Series A investors are getting more shares without putting more cash in the Series B round. In addition, the full ratchet provision will reduce the amount the Series B investors will be willing to pay in a down round (simply because full ratchet results in more shares outstanding on an "as converted" basis).

Weighted Average

A second and gentler method for handling dilution is referred to as the "weighted average" method. There are variations of weighted average formulas, depending on how "broad-based" or "narrow-based" they are. Broad-based weighted average formulas take into account shares that narrow-based do not, including shares that have not yet been converted (for example, outstanding employee options). Using a broad-based weighted average is more favorable to the founders and other existing stockholders because it results in a higher conversion price for the investors.

Following is the calculation for a typical weighted average anti-dilution provision presented by the NVCA model term sheet (it looks a little intimidating at first glance but it's actually pretty simple):

$$CP_2 = CP_1 * (A+B) / (A+C)$$

CP_2 = Conversion price immediately after new issue

CP_1 = Conversion price immediately before new issue

A = Number of shares of common stock deemed outstanding immediately before new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)[1]

B = Total consideration received by company with respect to new issue divided by CP_1

C = Number of new shares of stock issued

Let's suppose a company has 1,000,000 common shares outstanding and then issues 1,000,000 shares of preferred stock in a Series A offering at a purchase price of $1.00 per share.

[1] This is fairly broad-based, but the NVCA model term sheet points out that an even broader formula would include shares reserved (but not yet issued) for the employee option pool.

The Series A stock is initially convertible into common stock at a 1:1 ratio for a conversion price of $1.00.

Next, the company conducts a Series B offering for an additional 1,000,000 new shares of stock at $0.50 per share. The new conversion price for the Series A shares will be calculated as follows:

$$CP_2 = \$1.00 \text{ x } (2{,}000{,}000 + \$500{,}000) / (2{,}000{,}000 + 1{,}000{,}000) = \$0.8333.$$

This means that each of the Series A investor's Series A shares now converts into 1.2 shares of common (Series A original issue price/conversion ratio = $1.0 /$0.8333 = 1.2).

Under the discussion of full ratchet above, we noted that the preferred shares became convertible into 2 common shares post-issuance. Under weighted average, the preferred shares became convertible into 1.2 shares. This simple example illustrates that the weighted average approach is much less beneficial for the preferred stockholders but much less onerous for the common stockholders.

However, to provide a little more context, let's assume our hypothetical company is sold and liquidated for $10,000,000 after the Series B round. We'll also assume, for simplicity, that there was no dividend preference for the preferred shares and that we're using a non-participating structure. Here's how the cash gets distributed with full ratchet and weighted average, respectively:

Full Ratchet

	Actual **# Shares**	**Common** **As Converted**	**Fully Diluted** **Percentage**	**Liquidation** **Proceeds**
Common	1,000,000	1,000,000	25%	2,500,000
Series A	1,000,000	2,000,000	50%	5,000,000
Series B	1,000,000	1,000,000	25%	2,500,000
Total	3,000,000	4,000,000	100%	10,000,000

Weighted Average

	Actual **# Shares**	**Common** **As Converted**	**Fully Diluted** **Percentage**	**Liquidation** **Proceeds**
Common	1,000,000	1,000,000	31%	3,125,000
Series A	1,000,000	1,200,000	38%	3,750,000
Series B	1,000,000	1,000,000	31%	3,125,000
Total	3,000,000	3,200,000	100%	10,000,000

Note how much more the Series A investors get with full ratchet and how much this reduces the amounts distributable to Series B investors and common stockholders.

No Price-based Anti-dilution Protection

The third alternative for anti-dilution in the NVCA model term sheet is no price-based anti-dilution protection. In this scenario, the preferred investor bears the risk of a down round along with the common stockholders. This is the fairest from the standpoint of the common stockholders, but many preferred investors will not agree to take the down round risk without any anti-dilution protection.

Customary Carve-outs to Anti-dilution Provisions

An anti-dilution provision generally lists certain issuances of stock that do *not* trigger adjustment of the conversion price. These carve-outs comprise various common situations that are distinct from the typical capital raise, including the following:

- stock issued upon the conversion of any preferred stock or as a dividend or distribution on preferred stock;
- stock issued upon conversion of any debenture, warrant, option, or other convertible security;
- common stock issued upon a stock split, stock dividend, or any subdivision of shares; and
- common stock or options issued to employees, directors, or consultants as part of an equity compensation plan.

In addition, other issuances that do not trigger conversion can be negotiated by the parties. Other possible exclusions include the following issuances of common stock, options, or convertible securities:

- to banks or other financial institutions pursuant to a debt financing;
- to equipment lessors pursuant to equipment leasing;
- to real property lessors pursuant to a real property leasing transaction;
- to suppliers or service providers in connection with the provision of goods or services;
- in connection with an M&A transaction, reorganization, or joint venture; and
- in connection with sponsored research, collaboration, technology license, development, original equipment manufacturing, marketing, or similar.

Any of these exclusions can contain a limit on the number of shares or underlying shares that can be issued, and can require the approval of the director(s) appointed by preferred stockholders or even the vote of the preferred stockholders. Founders should be careful to review the carve-outs to ensure that the customary ones are contained in the term sheet. In addition, if the founders anticipate that the company may need to make use of any of the optional carve-outs described above, they should consider asking for those as well. Investors shouldn't find the typical carve-outs to be particularly problematic.

Pay to Play Provisions

"Pay to play" provisions work together with anti-dilution provisions to encourage venture capital investors to participate in subsequent rounds of financing. When such a provision is in effect, if an investor does not participate in a subsequent round, the anti-dilution provision does not apply. (The investor may lose other rights of a preferred stockholder as well, depending on how the provision is structured.) Because the investor will want that protection, it has an incentive to participate. Such a provision is favorable for the company because it prevents the investor simply from sitting out a down round and passively receiving the benefits of the anti-dilution provisions without committing more capital to the company. A pay to play provision is certainly something that a company can ask for when negotiating a term sheet, though the company should expect to receive some pushback. A company is only likely to get a pay to play provision if it has considerable leverage going into a deal.

Redemption Rights

The NVCA model term sheet includes a redemption rights provision. A typical redemption rights provision provides that a certain percentage of the preferred stockholders can vote, after a certain length of time has passed (five years is common), to cause the company to redeem all shares of the preferred stock for its original purchase price and possibly accrued and unpaid dividends. It thus functions as a put right. The redemption price can also be keyed to another measure, such as the fair market value of the stock at the time of redemption, but this is less common and should be resisted by founders. The redemption price can be required to be paid in a lump sum or in installments over some period of time.

Redemption rights will be limited by any applicable state law governing distributions to stockholders. That is, a corporation may generally not redeem shares when the payment would cause the corporation to be insolvent.

A redemption right appears to be, on its face, an exit option for investors. However, in practice, such redemption rights are rarely exercised. Remember the reason venture capitalists choose to invest in a given company — they are not hoping to merely recoup their investment, but rather looking for a big payoff — and within a short time frame, as VC funds generally have a limited life. This usually comes in the form of a sale of the company or an initial public offering. Investors usually won't want to get out of the game entirely if they are only getting a return of their original investment and maybe dividends.

However, there are scenarios in which venture capital investors might want to cut their losses, regain their investment, and look elsewhere. For example, if a company is hobbling along, not doing too badly but not growing either — what many refer to as a "sideways situation" — neither a sale nor an IPO are likely. Or perhaps if the investors think the company is tanking. These are both scenarios where investors may want to exercise (or at least threaten to exercise) their put rights, which could cripple a company needing cash.

Another thing redemption rights can do for venture capital investors is give them some leverage over the company during the period when redemption rights are exercisable. For example, venture capital investors may try to include provisions giving them extraordinary powers such as electing a majority of directors or the right to consent to cash expenditures until the redemption price is paid in full.

Founders should be aware that venture capital investors may expect the term sheet to include redemption rights. And while redemption rights are infrequently exercised, they should be thoroughly considered. Founders should beware in particular of any provisions that give investors the right to a price greater than their original investment or that trigger the redemption right early or under unusual conditions, as well as any burdensome provisions that would apply when redemption rights are exercisable.

Registration Rights

The NVCA model term sheet includes a registration rights provision, which gives investors the power to require the company to register the common stock issuable upon conversion of the investors' preferred stock with the Securities and Exchange Commission. It can also include other common stock held by the venture capital investors. (Note that stockholders other than the preferred stockholders, such as founders, may also negotiate for registration rights.)

Before diving into a discussion of registration rights, it is important to remember the significance of registering stock. Stock that has not been registered with the Securities and Exchange Commission and applicable state authorities cannot be freely resold, and thus represents a relatively illiquid investment for the stockholders. Federal securities regulations do permit the resale of unregistered stock to the public upon certain conditions, including a holding period of a certain length (at least six months depending on the circumstances) and other factors depending on whether the company is a public company and whether the stockholder is a company affiliate. A stockholder who wishes to sell or transfer shares at a particular time, however, may find that these conditions are not met and it is stuck holding the stock until the conditions are met or until the stock is registered. In addition, even if the regulatory conditions for a resale are met, venture capital investors often want the public, underwritten offering that accompanies a registration. Thus, venture capital investors will expect the term sheet to contain rights enabling them to require or participate in the registration of the company's stock, transforming their investment into a liquid (and perhaps more valuable) one. Registration, however, is not a simple or cheap process; it demands considerable resources from the company and results in extensive ongoing compliance and reporting requirements.

There are two types of registration rights, demand registration, and "piggyback" registration. Demand registration rights allow the holders of a certain percentage of registrable securities to require that the company register its shares after a certain period of time, typically three to five years after the investment or six months after an IPO. The number of times the investors can make this demand can be negotiated; one or two is usual. Piggyback registration rights, as the name implies, enable holders of registrable shares to participate in the registration of any other class of shares by the company.

A set of registration rights provisions typically also contains a few other elements, including:

- The right of holders of a certain percentage of registrable securities to require the company to register shares using Form S-3 (a simpler form than that required for an initial registration) for a certain total offering price from time to time;
- A provision allocating the payment registration expenses (often to the company);

- A "lock-up" agreement of investors and other stockholders to hold their shares after an IPO for a period of typically 180 days plus any number of days required to meet regulatory requirements (this postpones the date the investment becomes liquid, but is required by underwriters); and
- Termination of registration rights upon a liquidation event, when all of an investor's shares may be sold without restriction on resale, or on an anniversary of the IPO.

Founders should be aware that although having registration rights is important to venture capital investors, negotiating the details of the provisions in the term sheet is generally not something worth devoting a great deal of time to. When the time comes for an actual registration, the company's investment bank and the underwriter will decide upon the terms they believe will maximize the success of the offering, which may or may not match the provisions agreed to in an earlier venture capital financing. Terms that are worth paying attention to are how many times the investors are entitled to demand registration, because of the expense and employee time required to pull off a registered offering, and the size of registration the investors may demand.

Management Rights

The NVCA model term sheet contains a provision that requires the company to deliver a "Management Rights letter" to each investor who requests one. The NVCA model legal documents also include a sample model management rights letter.

The reason venture capital funds request such a letter is to avoid becoming subject to the requirements of the Employee Retirement Income Security Act of 1974, or ERISA, and its regulations. Many institutional investors who invest in venture capital funds are pension plans, and pension plans that are subject to ERISA are required to follow certain ERISA plan asset rules. Under these rules, the plan's assets must be held in trust and the plan's managers have fiduciary duties and are prohibited by ERISA and the Internal Revenue Code from engaging in certain transactions. If the plan invests in a venture capital fund, then generally the fund's assets are treated as the plan's assets and the managing partner of the venture fund is treated as an ERISA fiduciary (and therefore subject to all of the applicable ERISA rules). A venture capital fund can avoid these rules only by qualifying for an exemption from the ERISA plan asset rules. One such exemption under Department of Labor (DOL) regulations provides that if the fund is a "venture capital operating company," it is deemed not to hold ERISA plan assets.

Under the regulations, a venture capital fund is a "venture capital operating company" if at least 50% of its assets are invested in venture capital investments. These include investments in operating companies (other than venture capital operating companies) as to which the fund obtains "management rights." In addition, to qualify for the exemption, the venture fund must actually exercise these management rights with respect to at least one operating company a year. "Management rights" are defined as "contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company." A management rights letter, then, is intended to create these contractual rights so that the venture capital fund may legitimately avail itself of the exemption from plan asset rules described above.

In written opinions, the DOL has implied that the right to appoint a director or have a representative serve as an officer would be sufficient, but not necessary, and other sets of rights may suffice. DOL guidance indicates that the following set of rights set forth in a written agreement constitutes "management rights," as long as there is no limitation on the ability to exercise any of them, so they may be thought of as a safe harbor of sorts for the venture capital fund:

- the right to receive quarterly financial statements;
- the right to receive annual audited financial statements;
- the right to receive any periodic reports required by securities laws;
- the right to receive documents, reports, financial data, and other information as reasonably requested;
- the right to visit and inspect the company's properties, including books of account;
- the right to discuss the company's affairs, finances, and accounts with the officers; and
- the right to consult with and advise management on all matters relating to the company's operation.

The management rights may not exist "only as a matter of form"; they must be exercised regularly and the venture capital operating company must devote effort to their exercise. However, the portfolio company management does not have to comply with the venture capital operating company's advice or compensate it for its management activities.

The NVCA's model management rights letter includes the following rights:

- If the investor is not represented on the board, the right to advise management on significant issues and to have regular meetings with management;
- The right to access the company's books and records, inspect its facilities, and request information; and
- If the investor is not represented on the board, the right to receive material the company provides to directors and to address the board about significant business issues.

Some of the rights listed in the management rights letter may overlap with rights granted to investors generally, such as the information rights discussed below. Under ERISA regulations, however, the venture capital investor must have its own specific contractual rights; rights that all of the investors happen to share do not qualify.

The letter will generally provide that these rights terminate when the investor no longer holds shares, when the company's securities are sold in a registered public offering, or upon a merger or consolidation of the company.

Management rights letters are common practice in U.S. venture capital deals and are not usually heavily negotiated. However, founders should pay attention to the specific rights requested and make sure they will not be overly burdensome. As noted above, not all of the rights set forth in the DOL guidance need to be granted to exempt the venture fund from the ERISA rules.

Information Rights

The NVCA model term sheet also includes an information rights provision. This provision grants investors access to the company's facilities and personnel as well as the right to receive certain reports from time to time. The provision can limit these rights to only certain investors, such as major investors who hold at least a certain number of shares of preferred stock or those who are not competitors of the company. The provision contains limits to make it less burdensome to the company: investors can access the company's facilities and personnel only during normal business hours and with reasonable advance notice. The reports comprise annual and quarterly financial statements as well as a budget for the next year's monthly revenues, expenses, and cash position. They could also include monthly financial statements and a quarterly updated cap table, and other information as negotiated by the parties.

Information rights are customary in venture capital deals. However, as with management rights, founders should pay attention to the specific rights requested and make sure they will not be overly burdensome.

Preemptive Rights

The term "preemptive rights" refers to the right to purchase a company's new shares before they are offered to anyone else. The NVCA model term sheet includes a preemptive rights provision, titled "Right to Participate Pro Rata in Future Rounds." This provision entitles investors to participate in later securities issuances on a pro rata basis (assuming conversion of all preferred stock). The right can be limited to investors who hold a certain large amount of preferred stock. The right does not apply in the case of an issuance that would not trigger the anti-dilution adjustment, such as stock issued upon the conversion of preferred stock or stock issued as part of an equity compensation plan. If an investor chooses not to purchase its entire pro rata share, the other investors can purchase the remaining shares pro rata. This provision enables investors to maintain their original percentage ownership and avoid dilution if they choose to do so. (Contrast this with anti-dilution provisions, which enable investors to avoid dilution of the value of their investment, as opposed to their percentage ownership.) Maintaining percentage ownership can be key to an investor keeping certain voting rights, board appointment rights, or information rights, if those rights are conditioned on a certain percentage ownership.

Preemptive rights provisions might incorporate a "pay to play" feature, similar to that included with anti-dilution provisions. If an investor does not participate in a subsequent financing round by exercising its preemptive rights, certain penalties may apply, such as the conversion of its preferred stock into common stock at the pre-issuance conversion price. As with anti-dilution provisions, a "pay to play" feature gives investors an incentive to participate in future rounds.

Founders should be aware that preemptive rights provisions are standard and venture capital investors will expect to see them in the term sheet. They are not worth spending a lot of time negotiating. Founders should simply be careful that the investors don't attempt to make these provisions too onerous, for example by adding terms that are broader than the ones in the NVCA model term sheet, such as terms giving an investor the right to purchase any and all shares the company issues in the future, rather than just its pro rata share, or terms that do not include the customary carve-outs referenced above.

Drag-Along Rights

A "drag-along" provision requires the founders and certain other stockholders to enter into an agreement with the venture capital investor that will allow the investor (perhaps acting with certain other stockholders) to force a sale of the company if certain conditions are satisfied. This is a very key provision for consideration by founders and should be carefully reviewed.

There are several important concepts founders should understand with respect to the "drag-along" provision, including the following:

- which stockholders can elect to trigger the drag-along provision;
- must the board of directors also approve the transaction;
- the types of transactions that will trigger the drag-along rights;
- any limitations on the applicability of the drag-along provision;
- the potential liability of stockholders in a drag-along sale; and
- how the sale proceeds will be distributed.

Founders should be aware that drag-along rights are increasingly common and very important to consider. Founders should pay very close attention to the drag-along provision and should be prepared to negotiate some of the key terms discussed below, particularly those concerning who can trigger the "drag-along" provision and any minimum price requirement. A summary of each of these concepts follows:

Electing Holders

The NVCA model term sheet contemplates that the term "Electing Holders" (i.e., the stockholders who can trigger the drag-along right) is defined as holders of a certain percentage of the outstanding shares of preferred stock on an as-converted basis. Venture capital investors may commonly try to include 51% as the applicable percentage. For founders, this means that stockholders owning 51% or more of the preferred shares on an as-converted basis can force them to sell, even on terms that could be very unfavorable for the founders (as happened in the *In Re Trados Incorporated Stockholder Litigation* case discussed below).

Founders should carefully consider the definition of Electing Holders and may want to seek to require a higher percentage for approval (e.g., 66 2/3% of the preferred). In addition, founders may want to attempt to require some percentage of the common stock to approve the transaction as well (e.g., 66 2/3% of the preferred and more than 50% of the common). (Preferred stockholders may be able to convert some of their stock to common in order to make sure the required common vote is achieved, although they will usually lose some or all of their liquidation preference in doing so, which benefits the common.)

Board Approval

Drag-along provisions could include the requirement of board approval of a sale. However, as illustrated in the 2013 Delaware Chancery Court decision, *In Re Trados Incorporated Stockholder Litigation*, board approval of a sale can expose the venture investor-appointed directors to liability. In that case, a merger was approved for a price that was, in effect, below the preferred liquidation preference; i.e., the common stockholders received $0. The common stockholder plaintiffs claimed that the board breached its fiduciary duties to the company and the common stockholders by approving the merger. Eight years after the merger, the court ruled that the directors did not breach their duties because they were able to prove that the merger transaction was "entirely fair." Although this case exonerated the directors, it highlights the issue that is raised when the board has to approve a transaction such as a "drag along" sale.

Founders should push for board approval in the drag-along provision. Venture capital investors may resist the board approval requirement due to potential liability concerns, but they can incorporate mechanisms to protect their directors from claims of breach of duty.

Types of Transactions Subject to the Drag-along Provision

In the NVCA model term sheet, the drag-along provision comes into play when the Electing Holders (and the board, if applicable) have approved one of the following types of transactions:

- a merger or consolidation (other than one in which the company's stockholders own a majority of the survivor or acquiror);
- a sale, lease, transfer, exclusive license, or other disposition of all or substantially all of the company's assets; and
- a transaction in which 50% or more of the company's voting power is transferred.

This list of transactions is fairly standard and would not typically be heavily negotiated.

Price Limitation

A price limitation is one of the more important aspects for founders to consider. As discussed above under "Board Approval," a sale at a price below the preferred liquidation preference results in the common stockholders walking away with nothing. To avoid that result, founders might try to push for a minimum purchase price before the drag-along provision is triggered. For example, the minimum purchase price could be twice the total preferred liquidation preference. Venture capital investors might be reluctant to agree to this, however, since a transaction in which they exit the company at a price that doesn't leave much or anything for the common is exactly the type of situation in which they would need drag-along rights. Nevertheless, founders should carefully consider a minimum price requirement and seek to protect themselves from being "dragged" into a sale transaction that is very unfavorable.

Potential Stockholder Liability

When stock is sold, the sellers usually must give certain representations and warranties to the purchaser, and the seller has liability for breaches of those representations and warranties. That liability can either be joint or several. Under joint liability, each of the stockholders would be liable for the entire amount of any liability to the purchaser. Under several liability, each stockholder is only liable for its pro rata share of any liability. Drag-along provisions are often structured so that the stockholders being "dragged-along" are only required to subject themselves to several, rather than joint, liability. This is obviously more favorable and founders should insist on including it. In addition, founders should push for capping their liability at the amount of consideration they received.

How Proceeds Are Distributed

The NVCA model term sheet conditions the drag-along rights on the allocation of sale consideration as if it were liquidation proceeds to be distributed under the company's certificate of incorporation, including any liquidation preferences and preferred dividends. This provision is also fairly standard and not generally heavily negotiated.

Representations and Warranties

One of the items that the stock purchase agreement in a venture capital deal will include is the representations and warranties the company (and perhaps the founders) will make to the venture capital investor. Representations and warranties are the statements that a party to an agreement makes to the other party and upon which the other party is entitled to rely in entering into the transaction. They encompass both assertions about factual matters and promises that the facts truly are as stated, as of a certain date. The NVCA model term sheet provides that the company will make "standard" representations and warranties, and, as an option, that the founders will make representations and warranties regarding technology ownership, etc.

Since the details of the representations and warranties are usually negotiated after the term sheet has been signed, we won't go into detail here. That said, the "standard" representations and warranties in a venture capital deal are lengthy and quite involved and you will need counsel to assist you in negotiating them. The founders should not disregard them as mere boilerplate or legalese, even though they are extremely complex and opaque. They also should not assume that their obligation to disclose all of these matters is fulfilled simply by making all of the company's files available to the venture capital investor. The founders should carefully read and digest each of the statements and promises the company is making and prepare thorough lists or descriptions of any exceptions, keeping in mind that if any of the statements the company is making is untrue, or any of the promises the company is making is breached, then the venture capital investor may be entitled to damages. The founders may feel that the company cannot make certain blanket statements with a high degree of confidence – for example, the founders may not be 100% sure that the company's intellectual property does not violate the intellectual property rights of any third-party anywhere in the world. From the venture capital investor's point of view, however, the company should be the one to give assurance on that point in the agreement and bear the risk of liability in case it should prove untrue.

One issue that does arise during the term sheet stage is whether the founders will also be giving representations and warranties personally. Founders' representations and warranties are not included in every venture capital purchase agreement. They are more likely to be included if the founders are to receive liquidity, if there are intellectual property concerns, or in international transactions. They are more likely to be included in an initial venture capital round, in which the founders bear greater risk, than in any later rounds. Founders should avoid making significant representations and warranties, if possible. If the founders cannot avoid making representations and warranties, the founders should request that the representations and warranties be made severally and not jointly, which means that each founder is responsible only for his proportionate share of the liability. Founders can also negotiate to have their liability for breaches limited to the then-current fair market value of the shares of company common stock currently owned by that founder and have that liability terminate on the earlier of the first or second anniversary of the agreement or an IPO.

The following is a list of typical founders' representations and warranties:

- Conflicting agreements — a statement that the founder is not in violation of any fiduciary or confidential relationship, any agreement, or any judgment, decree, or order, and none of these conflict with the founder's obligations to promote the company's interests or with the venture capital agreement.
- Litigation — a statement that there is no pending or threatened litigation or investigation against the founder or any basis for any litigation.
- Stockholder agreements — a statement that there are no agreements relating to the acquisition, disposition, registration, or voting of the company's securities.
- Prior legal matters — a statement that the founder has not been subject to a petition under bankruptcy laws, the appointment of a receiver, or similar occurrence, convicted in or subject to a criminal proceeding, subject to any court order, judgment, or decree limiting the founder's engagement in business or acting as an officer or director of a public company, or found by a civil court, the SEC, or the CFTC to have violated any securities, commodities, or unfair trade practices law.
- Company representations and warranties — a statement that the company's representations and warranties are true and complete.

If the founders agree to make representations and warranties, they should be aware that they are assuming personal liability risk. The last representation in the list above is the most difficult one for founders to make, because they are essentially guaranteeing all of the company's representations and warranties; if any are untrue or are breached, the founders' personal assets are on the line. The venture capital investor, however, may insist that the founders stand behind the company's representations and warranties to ensure that such representations and warranties are correct and so that it has recourse other than against the company it has invested in. The discomfort founders may feel about risking everything they own can be ameliorated by limiting their liability, as described above, to a certain amount and within a certain time frame. Given the high stakes that are involved in negotiating these issues, founders should not ignore them.

Rights of First Refusal

The NVCA model term sheet contains a right of first refusal in favor of the company and the venture capital investor. If the founders ever want to sell any of their shares to a third-party, the right of first refusal requires them to give the company the first opportunity to purchase the shares on the terms offered by the third-party. If the company doesn't exercise its right of first refusal, the venture capital investor then has the opportunity to purchase the shares on the same terms. If both the company and venture capital investor forego their rights of first refusal, then the founders may proceed to sell their shares to the third-party. A right of first refusal is designed to control which parties may own a significant number of shares in the company and give the venture capital investors the first opportunity to purchase shares if they desire to do so. While the right of first refusal appears not to limit the founders' ability to transfer their shares, it can have that impact (third parties may not spend the time to negotiate a deal with founders if they believe the company or venture capital investor can step in and take their offer via the right of first refusal).

If there is more than one venture capital investor and the investors exercise their right of first refusal, each investor may participate in the purchase pro rata based on the number of shares held by each. If any investor declines to participate in the purchase, the others have a "right of oversubscription" to purchase the shares that the non-purchasing investor was entitled to purchase, again pro rata based on the number of shares held by each purchasing investor.

A right of first refusal applies to all "transfers" of shares, which encompass a variety of dispositions in addition to outright sales. Definitions of "transfer" typically include offers to sell, assignments, pledges (for example, to secure a debt), mortgages, grants of options, and encumbrances, of the shares themselves or any interest in the shares. The definition can include involuntary transfers, such as those that happen upon death or divorce. The NVCA model term sheet points out that the parties will negotiate exceptions, for example for estate planning purposes or in the case of transfers of very small amounts. If the consideration to be paid by the third-party is property or services or other non-cash consideration, the board of directors of the company may have the right to determine the fair market value of the consideration, and those exercising the rights of first refusal can pay the cash equivalent of such value.

While rights of first refusal are common in venture capital deals, founders should pay attention to the particular details of what is proposed and make sure they are customary and not overreaching. For example, founders can (and should) negotiate a provision that provides that those exercising the rights of first refusal must purchase all (and not less than all) of the stock subject to the rights or they forfeit their right to do so. This prevents investors from disturbing the deal with the third-party and not purchasing all of the subject stock. Also, founders should make sure the rights of first refusal do not apply to their preferred stock (if any) or any common stock issued upon conversion of preferred stock. The theory is that the founders have purchased this stock and so the rights of first refusal should not apply.

Rights of Co-Sale

The NVCA model term sheet also contains a right of co-sale (also called a "take-me-along" provision or a "tag-along" provision) for the venture capital investor. If the founders wish to sell their shares and the shares are not purchased pursuant to the rights of first refusal (discussed above), they must give the venture capital investor the opportunity to participate in the sale pro rata based on the number of shares held by the selling founders and by the participating investors. This gives the investor the opportunity to a partial exit from the company along with the founders if the latter are presented with the right opportunity. If the transaction with the third-party constitutes a "Change of Control" (e.g., shares representing more than 50% of the voting power), the co-sale provisions may require that the aggregate proceeds be divided among the selling stockholders in accordance with the Certificate of Incorporation as if the transaction were a "deemed liquidation event"; this gives the investors their liquidation preference upon a sale to a third-party.

Like rights of first refusal, rights of co-sale are also common in venture capital deals and negotiation should focus on making sure there isn't anything unusual included.

Closing Conditions

Conditions to closing in an agreement are events that must take place or tasks that must be completed before the transaction can be consummated. A stock purchase agreement sets forth an agreement for one party to purchase stock from the other, but the purchase may not actually happen on the date the parties sign the agreement. It might happen on a future "closing" date, after specified conditions are satisfied. This is appropriate, for example, when the transaction requires governmental approvals that take some time to obtain. The NVCA model term sheet provides that the stock purchase agreement among the company, the founders, and the venture capital investor will contain "standard" closing conditions, including satisfactory completion of due diligence, qualification of the preferred stock under state "blue sky" securities laws, filing of an amended certificate of incorporation for the company establishing the new preferred stock to be issued, and an opinion of the company's counsel. All of these conditions must be satisfied before the venture capital investor is actually obligated to purchase the company's preferred stock (unless the parties waive any of them). Following is a brief discussion of each of these conditions.

Due Diligence

The venture capital investor will perform an investigation of the company's financial and legal affairs and history, known as "due diligence." Naturally, if the investor discovers anything during this investigation that causes it to rethink its decision to invest in the company, it will want an "out" to avoid having to complete its purchase. Thus, the stock purchase agreement conditions the investor's obligation to close on the "satisfactory completion" of the due diligence investigation. Founders will want to respond quickly and thoroughly to the investor's due diligence requests in order to avoid unpleasant surprises late into this expensive and painstaking process that could prevent a closing. The due diligence condition in the stock purchase agreement is usually not a major factor, as the investors will often complete their investigation prior to execution of the definitive documents.

Blue Sky Qualification

State securities laws that govern the offer and sale of securities are known as "blue sky" laws. With some variation, each state requires that offers and sales of securities in that state must be registered or qualified, and the persons conducting the offering or sale of securities must be registered as broker-dealers, unless an exemption is available. Counsel to the company will determine which states are involved in the transaction and, therefore, which states' blue sky laws apply. Most states have exemptions from the lengthy and expensive registration and review process for limited offerings of securities to certain types of purchasers, which often cover venture capital transactions. In the event qualification is required, however, it must be complete and the relevant state agency's approval obtained before the investor is obligated to close the stock purchase.

Amended Certificate of Incorporation

The characteristics of all classes of a corporation's stock must be set forth in its certificate of incorporation (which in some states might be called a charter or articles of incorporation). Since the venture capital investment involves the creation of a new class of preferred stock, an amendment to the company's certificate of incorporation establishing the rights and preferences of that class must be filed before the investor is obligated to purchase any shares of that stock.

Opinion of Counsel

It is common in venture capital transactions for the company's counsel to deliver an opinion letter to the investor covering such legal matters as the company's valid formation, power to conduct business, and valid issuance of stock. The investor relies on the legal conclusions in the opinion in making its investment. The company's lawyers will need to review the company's corporate documents and minute books and get various certifications from the company's officers and directors in order to prepare this opinion. Founders sometimes find out at this stage, to their chagrin, that they have not properly observed corporate formalities in the past, and need to go back and ratify their past actions. The inclusion of an opinion letter as a closing condition adds to the expense of the transaction for the company and, if possible, founders should try to negotiate the removal of this condition.

Other Conditions

Some other typical conditions to each party's obligations to close include the following:

- The other party's representations and warranties are true and correct as of the closing and the other party has performed all of its pre-closing obligations.
- As of the closing, the board of directors is a certain size and comprises certain members.
- The other party has executed and delivered various related agreements and documents.
- A minimum number of shares has been sold at the initial closing (when there is more than one closing).

The conditions to closing in a venture capital transaction are largely standard and in many cases amount to no more than a checklist to guide the lawyers in exchanging signed documents at the closing. Be on the lookout, however, for anything atypical, especially when the approval or consent of third parties is required, as that can be time-consuming or even prevent a closing from taking place.

Expenses

A venture capital term sheet typically sets forth who will draft the stock purchase agreement and other transaction documents — counsel to the venture capital investor or counsel to the company. The term sheet also states who will pay the expenses of the deal. It is usual for the company to pay the legal and administrative costs of the transaction, including the fees of the investor's attorneys. Given that, it is generally less expensive for the company to designate its own counsel to prepare the transaction documents, as it will have more control over the time spent by its own counsel. Founders may wish to try to limit the investor's legal fees to a specified cap. Expenses are often paid at the closing of the transaction from the proceeds of the investment. The expenses section is often listed as one of the binding sections of the term sheet, which in practicality means that if the deal doesn't close, the company would still have to pay for the investor's legal fees. If that is the case, founders should at least ask for a clause providing that the company is not required to pay expenses if the deal doesn't get done because the investor withdraws its commitment without cause.

Non-Competition and Non-Solicitation Agreements

The NVCA model term sheet provides that each founder and key employee will enter into a non-competition agreement and non-solicitation agreement. The non-competition provisions will restrict the founders and key employees from competition with the company while they are employed and for a specified time thereafter (usually one to two years) and within a specified geographical area (which could be the entire United States or beyond, if the company's business is national or international). The non-solicitation provisions will restrict the founders and key employees from soliciting the company's existing (and perhaps potential) customers and employees.

While covenants not to compete and solicit customers and employees are common in employment generally and also in connection with venture capital transactions, their enforceability depends on the state law governing the agreement (which the parties will select, and is often the state law governing the other transaction documents). Some states look with disfavor upon such agreements, especially when not in the context of a business sale. Some states require that such agreements be supported by some type of consideration — something the employee gets out of it — which might not be satisfied by the company's mere continuation of the employee's employment.

Founders of companies receiving venture funding should expect to be presented with non-competition and non-solicitation agreements, but they should not be dismissed as extra paper for the deal. They can come back to haunt the founder if the founder and the company part ways down the line, and should be carefully reviewed and various future scenarios considered. Founders should make sure that the key terms (scope of the "competitive activity" restricted, the geographic area, and the term) are as narrowly drawn as possible. In some circumstances, founders might also ask for additional compensation in exchange for entering into the agreements.

Non-Disclosure and Developments Agreements

The NVCA model term sheet includes a provision requiring each current and former founder, employee, and consultant of the company to enter into a "non-disclosure and proprietary rights assignment agreement" in a form reasonably acceptable to the venture capital investors.

Non-disclosure agreements (also often called confidentiality agreements) are common in a variety of business contexts. Parties enter into them to protect the confidential information of one or both of the parties (in the latter case, the agreement may be called a mutual non-disclosure agreement). They generally define what constitutes confidential information, list types of information that are excluded from the definition, describe how each party can use the confidential information and the circumstances in which it can be disclosed (such as when the recipient is compelled by a governmental authority in a legal proceeding), and provide for the return or destruction of confidential materials when an employment or other relationship ends. Most importantly, they describe the remedies available to a party if the other party breaches its confidentiality obligations, including injunctive relief.

A "developments agreement" (also known as a "proprietary rights assignment" or an "assignment of inventions") is intended to ensure that the company actually owns its intellectual property. Such an agreement is a contract between the company and an individual founder, employee, or contractor which requires that person to assign over all intellectual property rights conceived in the course of that person's work at the company. This agreement is needed because, by default, intellectual property is frequently not assigned automatically to the company. For example, if the company hires an outside developer to write software for the company, absent an assignment of inventions, in most cases the copyright to such software remains with the developer. The company merely receives a license to use the software. This creates a significant due diligence issue for the company when the company seeks venture capital investment.

Both nondisclosure and developments agreements are important to venture capital investors and would be crucial in an eventual sale of the company. The NVCA term sheet typically requires such agreements from all current and former founders, employees, and consultants. Alternatively, a term sheet might simply specify certain key employees and founders. When negotiating this part of the term sheet, founders should pay careful attention to the list of parties from whom they will be required to obtain these agreement. It can often be difficult to track down former founders, employees, and consultants — in some situations, the remaining founders might not even be on good terms with such people. Ideally, the company will have obtained such agreements with these people at the beginning of the relationship. If the agreements were well drafted, they may satisfy the venture capital investor. Early stage companies, however, sometimes don't do a great job of getting these agreements in place at the beginning of relationships, as entrepreneurs frequently don't understand how crucial it is to get these agreements in place and the consequences for failing to do so. Founders will need to be prepared to track down everyone who played a significant role in developing the company's intellectual property and obtain from them nondisclosure and developments agreements acceptable to the venture capital investor. If the company is unsuccessful in doing so, depending on how important the holdout's role in the company was, the deal could potentially fall through.

Board Matters

The NVCA model term sheet groups a number of terms under the umbrella of the "Investor's Rights Agreement," the title of which is fairly self-explanatory. This is an agreement between the company, the venture capital investor, and perhaps certain key stockholders that sets forth certain rights the venture capital investor expects to accompany its investment in the company, including rights we have previously discussed like registration rights, management and information rights, the right to participate in future rounds to maintain its percentage ownership, and the right to have the investor-appointed director approve certain matters. Another minor set of investor rights this agreement generally includes is categorized in the model term sheet as "board matters."

The first term under this category is an optional one: each committee of the board of directors of the company must include at least one director appointed by the venture capital investor. Companies generally don't institute board committees until the board expands to more than a few directors, but if the size of the board justifies committees, such as audit and compensation committees, a venture capital investor will want to have the management rights afforded by appointing a director to each.

The second term in the category provides that the board will meet at least monthly or quarterly unless a majority of directors otherwise agree by vote. Early-stage companies often overlook conducting these meetings on a regular basis, at which certain corporate actions should be approved, such as the appointment of officers. A venture capital investor will want to ensure that these meetings take place regularly.

The third term provides that the company will procure directors and officers liability insurance (called "D&O insurance") with a carrier and in an amount satisfactory to the board. D&O insurance covers directors' and officers' legal fees, settlements, and other costs if they are personally sued by stockholders, employees, competitors, suppliers, customers, or others. Even before a venture capital investment is contemplated, the company's directors and officers may have demanded this coverage as a condition to serving in those roles, to protect their personal assets. If this coverage is not in place, the venture capital investor will demand it.

Finally, the term sheet provides that the company will enter into an indemnification agreement with each director appointed by the venture capital investor that is acceptable to the director. Some venture capital investors will request that the venture capital fund itself also be party to the agreement in addition to the director appointed by it, for additional protection. While the corporate statutes that govern a company permit indemnification of directors, they do not require it, so directors want companies to provide for mandatory indemnification in certain circumstances and perhaps more favorable terms than those outlined in the relevant statute. The company's certificate of incorporation or bylaws can include mandatory and permissive director indemnification, but directors prefer a separate indemnification agreement because it cannot be amended without the approval of the directors being indemnified.

All of these terms are typical and would not be negotiated at the term sheet stage. The venture capital investor will see these as essential to protecting its investment, and none should be objectionable to the company or its founders, as long as any D&O insurance and director indemnification applies equally to the directors not appointed by the venture capital investor.

Founders' Stock

The NVCA model term sheet provides, in the section labeled "Other Matters," that the founders' ownership of their shares of company stock will be subject to the company's right to buy a certain percentage of that stock back at cost. The buyback right is effective for a certain period of time after the closing of the venture capital transaction — twelve months is suggested — and then lapses in equal increments over a given period of time. The increments could be monthly, quarterly, or even annually.

Often before a startup has raised any significant money from sophisticated investors (like venture capital investors), founders own their company stock outright. When founders incorporate a company, they generally contribute capital and/or services to the company and the company issues shares to them. They may acquire more shares from time to time in exchange for cash or services. The founders and other stockholders might enter into a stockholders' agreement that restricts transfer of shares, but generally they own their shares absolutely.

When a venture capital investor enters the picture, however, that investor wants assurance that the founders will not take the VC money for the company and abandon ship. When the company has the right to buy back the founders' stock for a certain period of time, the founders have an incentive to remain with the company and work toward its success until the right lapses. It is important to note that this mechanism does not apply only to stock issued after the closing of the venture capital transaction; it applies to the stock the founders already own.

The company's buyback right means essentially that the founders' stock vests, just as employee stock options vest. Employee stock options typically vest under a schedule where 25% vests after one year and the remainder vests monthly or quarterly over the next three years. Founders' stock often vests on a different schedule. Because the founders in most cases have already contributed capital and/or services to the company and grown it to the point that it is ready for a venture capital deal, the investor will often not require 100% of their stock to be subject to the buyback right; 75% is common. In that case, 25% of the founders' stock would be treated in effect as already fully vested. The remainder usually vests over three to four years. This period can be measured from the closing date or from the date the founder purchased the stock.

The company's buyback right is triggered if a founder's employment with the company ceases. This might be for any reason, for example whether the founder quits, is fired for cause, or is fired for no cause. Alternatively, it might be triggered only if the founder's employment is terminated for any reason other than without cause.

The company buyback right is a standard item in a venture capital term sheet. At the term sheet stage, the points to worry about are the percentage that is exempt from vesting (or treated as if already vested) and the vesting schedule. The details will be hashed out when the transaction documents are prepared. The founders' stock provisions are often contained in a stock restriction agreement. At that point, the founders might attempt to negotiate for full or partial accelerated vesting upon the occurrence of certain events, such as the founders quitting for certain reasons or being terminated without cause or the company being sold. The founders will also want to take note at that stage of the buyback price, which is often the price the founders paid for the shares being repurchased. Before the deal closes, founders will want to check with their tax advisers and consider any necessary elections to avoid paying taxes on the increase in the value of shares upon vesting before the company distributes any cash.

Although founders might think it unfair that stock they already own should be made subject to vesting in a financing, they should recognize that the buyback right benefits them too, protecting each founder in the situation that another founder leaves the company, as well as the other common stockholders generally, who will experience an increase in ownership percentage should the company purchase and retire any founder stock.

No-Shop and Confidentiality Provisions

One of the last sets of terms in the NVCA model term sheet is the "No Shop/Confidentiality" section. The terms in this section are binding even if the venture capital transaction is never completed. The no-shop obligation requires the company and the founders not to solicit any offer of an investment in the company by a party other than the venture capital investor for a certain period. The investor may also require the company and the founders to agree not to solicit any offer for the acquisition of the company, whether by stock or asset purchase. The company is required to work "in good faith expeditiously" towards a closing of the venture capital transaction — this language is intended to prevent the company from stalling out the deal if it comes to believe a better opportunity might be in the offing after it has entered into the term sheet. The company and founders are required to notify the investor of any third-party inquiries promptly; this includes offers the company and founders did not solicit or encourage.

The NVCA model term sheet offers, as an option, a liquidated damages provision requiring the company to pay a specified "break-up fee" if it breaches the no-shop and actually closes an investment or sale transaction before a designated date. The language might provide that the break-up fee only applies if the venture capital investor is not given the opportunity to participate in the transaction on the same terms as the other party. The NVCA model term sheet notes that break-up fees are not common in a venture capital financing, but could be considered if the company is likely to be sold before the closing, such as in a later round.

The confidentiality provisions provide that the company may not disclose the terms of the term sheet itself to anyone other than its officers, directors, accountants, and attorneys and other potential investors without the venture capital investor's consent.

The no-shop and confidentiality provisions are standard (although not universal) in term sheets. The only points that the founders need worry about are the length of the period during which they cannot actively seek another investor or buyer (if applicable) and whether the investor presses to include the optional provisions extending the no-shop to acquisitions and imposing a break-up fee. The no-shop period is typically one to three months from the date the terms are accepted; the shorter the period, the more favorable to founders, although they should recognize that due diligence and document preparation take a certain amount of time and the founders' own responsiveness plays into how quickly those activities can be accomplished. The application of the no-shop to acquisitions and the break-up fee are issues for later-stage companies to consider. Founders should recognize that a no-shop obligation with a specified period facilitates the transaction for both parties: the investor has some degree of assurance that the founder is committed to doing the deal and will hold off seeking other investors for the no-shop period, and the founders can expect the investor to endeavor to complete its due diligence, finalize the detailed terms, and deliver the transaction documents before the end of the period.

Conclusion

Receiving a first venture capital investment can be a significant step forward for a startup. However, it's important that the terms of the investment are favorable for the company and its founders. While the valuation of the company is often the main focus of the founders, the other terms such as liquidation preferences, dividends, and drag-along rights have enormous economic impact on the founders at an exit event, sometimes even more than the valuation. Therefore, founders who choose to negotiate the details of their investment rounds will be glad that they did.