Analysis of a Venture Capital Term Sheet

This text will serve as a memorandum that will reflect the professional and legal views of its author upon the term sheet that was recently provided by the venture capital investor RHAND Ventures, L.P. to the Founder of Boomerang Vehicle. The clauses discussed herein reflect the ones which the author suggests to negotiate or reject completely. Unless specifically addressed, all other terms are deemed acceptable as they balance the interests of both the founders and the investors.

Firstly, the *liquidation preference* clause in the term sheet obligates the founders to provide a specific amount of money to the investors in case of company liquidation, with the current request being 1.5 times (1.5x) the original investment plus accrued dividends. While this demand is not unheard of, it is worth noting that a one-time (1x) liquidation preference is more common in such situations[1]. This is because lower liquidation preferences provide greater incentives for investors to promote the company's success. Additionally, the term sheet stipulates for cumulative *dividends*, which means that preferred stockholders are entitled to dividends regardless of the company's losses or profits, with any unpaid dividends accumulating for future payment. This can be challenging for new startup companies with difficulties making immediate profits. On the other hand, non-cumulative dividends offer greater flexibility in profit distribution.

Given the above, I suggest negotiating for a one-time (1x) liquidation preference and non-cumulative dividends. However, I anticipate that investors may push back on these terms. In such a scenario, my recommendation is to accept the current liquidation preference of 1.5x but maintain the position for non-cumulative dividends.

Secondly, regarding the *initial conversion rate* and the *anti-dilution* clause, it appears that they heavily favour the investor. The current initial conversion ratio of 2:1 and full ratchet anti-dilution formula are not balanced in favour of the founder. Experts like Wilmerding recommend a more balanced approach that takes both the interests of the investors and founders into account[2]. He suggests an initial conversion ratio of 1:1 and anti-dilution based on the weighted average (BBWA) formula[3]. Therefore, my suggestion would be to negotiate for the same terms as suggested by Wilmerding, as this would be more equitable for both parties involved.

Additionally, the *automatic conversion* clause appears to have potentially harmful terms for both parties. The term sheet outlines two conditions for this clause to take effect: first, if a public offering exceeding 40 million euros is offered, and second if half of the preferred stockholders consent to it. The first condition is favourable for the investor, while the second is advantageous for the founder. Wilmerding suggests a more balanced approach to this

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[1] Ritika Puri, 'What Is a Liquidation Preference?' (*AngelList Venture*) <https://learn.angellist.com/articles/liquidation-preference> accessed November 2, 2022

[2] Alexander Wilmerding, *Term Sheets & Valuations - A Line by Line Look at the Intricacies of Term Sheets & Valuations* (Aspatore 2001)

[3] Ibid. 47 & 55

clause. For the first condition, he advises setting the threshold at 25 million euros, and for the second term, he suggests raising the number of preferred stockholders needed to consent to two-thirds (2/3)[4]. This approach provides protection for both the founders and investors, as it allows the company to be sold if a favourable opportunity presents itself (even if it's less than 40 million), while still ensuring that the investors' interests are safeguarded by requiring a higher supermajority vote. Therefore, I recommend negotiating in accordance with Wilmerding's advice.

Thirdly, the *pay-to-play* clause warrants negotiation. Although it serves to ensure continued investment from the current investors, the current language of the clause appears overly strict, as it deprives preferred stockholders who fail to comply with the clause of their rights, even if the company is in good financial standing. As such, I would recommend limiting the application of the clause's penalties to instances of non-compliance during down rounds, where investors are likely to acquire a larger stake in the company. By doing so, both the founder's and investors' interests can be better protected, and a more balanced approach can be achieved.

Fourthly, regarding the *protective provision* paragraph 8 (viii), it stipulates that the consent of at least a majority of shareholders is needed for the company to distribute profits (dividends). However, Wilmerding argues that this term is too favourable for investors and that a more balanced approach would not require investor consent for dividends[5]. I agree with this recommendation and suggest negotiating to remove the consent requirement.

Fifthly, the current *drag-along* clause stipulates that a supermajority (66%) of preferred shareholders' consent is sufficient for the sale of the company. While this is a standard provision, it may not always be in the best interest of all parties involved. Therefore, I would recommend negotiating for an additional condition, such as a minimum sale price (e.g., 2x liquidation preference), to ensure that the sale is favourable for both the investors and the founders. This would provide more protection for the founders' interests while still allowing for a smooth sale of the company.

Sixthly, the *board of directors* clause, which stipulates its composition and voting procedure, appears to favour the investors. The term sheet demands that preferred shareholders will be able to elect two board members and the CEO, out of a total of four board members. This setup grants too much decision-making power to the investors. A more balanced approach would be to follow Wilmerding's advice of having five board members. One board member can be elected exclusively by the preferred stockholders, two board members should be elected exclusively by the common shareholders, and the remaining two board members, one of whom will be the CEO, should be elected by both types of shareholders[6]. This approach ensures that both the investors and founders have a fair say in the company's decision-making process.

[4] Ibid. 50
[5] Ibid. 58
[6] Ibid. 60

And lastly, the maximum amount of the *legal fees and expenses* that the company should pay for both parties is around 25,000 - 30,000 euros[7].

[7] Ibid, p. 81