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Early-Stage Term Sheets

In seeking funding for an early-stage company, the entrepreneur and investor will confront choices about not only the amount, but also the terms and conditions, of the financing. These terms are usually set forth in a *term sheet* that contains a host of provisions designed—in varying degrees—to protect the value of an investor's capital. These terms define the investor's rights as a holder of a senior security to common stock and are designed to secure the investor's ownership position, provide the right to monitor and control important company decisions, and facilitate exit from the investment. The note focuses on a few key aspects of these terms—antidilution (AD), liquidation preference, dividends, control rights, and redemption—all of which are widely regarded by practitioners as having the greatest ability to affect the economic returns for the parties involved in an early-stage investment.

Although in any given transaction a particular issue could arise that would require terms other than those covered here, most early-stage investments require a basic understanding of these terms because they cover rights relating to the preservation of capital and the size of the potential returns. These rights will be of concern to both entrepreneurs and investors in all early-stage deals. At the end of the discussion of each term, a chart highlights how these terms can be structured through the negotiating process to fall on a spectrum between investor-friendly terms and entrepreneur-friendly terms. Although not meant to be exhaustive, the examples offer a perspective on how a term can be worded in order to confer differential rights between the parties.

Types of Securities

After making the decision to invest in an early-stage company, an investor must consider the type of securities that will provide the capital for the deal. The most basic form of equity is common stock, but investors in early-stage deals rarely use it. Instead, investors most frequently choose to fund an early-stage round with a senior-equity security such as convertible preferred stock. One of the virtues of common stock is its simplicity, and some might say inherent fairness, which derives from its proportional claim on the firm. For example, if investors hold 10% of a company's equity, they are entitled to receive 10% of the dividends or value of the equity. Although this proportionality works well in a number of corporate contexts, it does not provide early-stage investors with any advantage over the entrepreneurs and other company stockholders. Given the high risk and investors' desire to protect their rights from other common shareholders, investors seek a senior security to common stock that can convey a nonproportional claim or superior rights in certain circumstances. Investors can achieve a certain amount of control and downside protection with preferred stock that cannot be achieved with common stock, and as such, most investors structure their claims in early-stage companies with convertible preferred stock. At exit, convertible preferred stock converts to common equity at the option of the holder, and the term sheet defines the conditions under which this conversion takes place. The conversion typically allows investors to participate in the upside created by their efforts, but it also protects

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their downside should the deal not develop as originally envisioned. Thus investors gain the upside but do not lose proportionally on the downside—an asymmetric outcome is not achievable with common stock.

Several other kinds of securities can be used in early-stage investments, including debt and a hybrid form of security.[1] Common forms of debt securities include subordinated debentures with warrants and convertible subordinated debentures. An angel round of financing can consist of a bridge loan in the form of convertible debentures with warrants where the debentures convert into Series A preferred stock upon the first round of venture capital (i.e., the Series A round). The warrants provide an extra upside to the investor for providing funds early in the life of the enterprise. Because these types of securities arise less frequently, this note focuses on convertible preferred stock (hereafter referred to as "preferred stock") as the main security used by early-stage investors.

We now turn to the discussion of the specific terms and provide examples of how these terms affect the returns to investors and entrepreneurs.

Antidilution

Most early-stage investments involve more than one round of funding, and AD is a term that seeks to protect investors from the changes that can occur between the rounds of investment.

Non-price-based AD

The most basic form of AD protection is often referred to as *structural* (*non-price-based*) *AD protection*, which protects against the effects of stock dividends, stock splits, reverse splits, and other recapitalizations. Structural AD adjusts the *conversion price* (CP) on the preferred stock (which is initially set to be the same as the original purchase price) to account for these events. Depending on the triggering event, the CP adjusts to ensure that the preferred shareholders receive the appropriate number of common shares upon conversion so that their original percentage of ownership is maintained. For example, suppose the preferred shares are originally sold to investors in the round for $2.00 a share.

- The CP at which the preferred stock will convert into common stock is initially set at $2.00 a share (ensuring a one-to-one conversion into common stock).
- The company decides to have a four-to-one stock split of its outstanding common shares.
- The conversion price is reduced to $0.50 (i.e., one-fourth of its previous price).
- Each preferred share would now convert at the ratio of $2.00/$0.50, or four common shares for each preferred share.

Another form of non-price-based AD protection is a *right of first refusal* (also called a *preemptive right* or a *right to participate*). These provisions allow the preferred stockholders to purchase a pro rata share of the company's future stock issuances (or sales of stock by the founders), thereby permitting the investors to maintain their percentage ownership. These provisions are particularly important in protecting the investors' ownership percentage in an "up round" of financing (e.g., when the Series B round price exceeds the Series A round price). It is common for these rights to be accompanied by an exception for the sale of stock to strategic partners, consultants, employees, or directors. Another condition often placed on these rights is that an investor must

[1] It is important to note that each type of security has different economic, tax, and accounting characteristics for both the investor and the company.

hold a minimum percentage of preferred stock in order to exercise such a right. Furthermore, in exchange for granting such rights, an entrepreneur may request that the right be reciprocal (i.e., request that the company or entrepreneur have a right of first refusal on sales of the preferred stock by the investor).

Price-based AD

Price-based AD differs from non-price-based AD because it is triggered by reductions in the price of shares sold to investors in subsequent rounds (hence the "price-based" reference in the name). The valuation of early-stage companies is highly uncertain, and investors could be investing in a company whose value adjusts downward before it stabilizes and resumes positive growth. For this reason, investors often seek price protection—that is, protection from the dilutive effects of a later round of financing that is priced below the price at which they bought into the company. There are two common forms of price-based AD protection: *full-ratchet AD and weighted-average AD* (WAAD).

Full-ratchet AD protection: Full-ratchet AD is generally considered a severe form of AD protection because it forces the common shareholders to absorb most of the dilution. It lowers the CP on the original round to the subsequent round's price. The effect of full-ratchet protection on the common shareholder is illustrated in **Table 1**. The example makes the following assumptions:

- Common shareholders (including founders) own 7.5 million shares.
- In the first round, Series A preferred shareholders buy 2.5 million shares at $1.00 a share for $2.5 million.[2]
- In a later second round, Series B preferred shareholders buy 2 million shares at $0.50 a share (*down round*) for $1 million.

Table 1. The effect of full-ratchet AD protection.

	Conversion Price of Preferred Shares	**Shares Issued (in millions)**	**Common Shares after AD Conversion**	**Percentage of Company Owned**
Second-Round Capitalization—Before Full-Ratchet AD Protection				
Common shares		7.50	7.50	62.50%
Series A preferred shares	*$1.00*	2.50	2.50	20.83%
Series B preferred shares	*$0.50*	2.00	2.00	16.67%
Total shares		12.00	12.00	100.00%
Second-Round Capitalization—After Full-Ratchet AD Protection				
Common shares		7.50	7.50	51.72%
Series A preferred shares	*$0.50*	2.50	5.00	34.48%
Series B preferred shares	*$0.50*	2.00	2.00	13.79%
Total shares		12.00	14.50	100.00%

Source: All tables created by note writer.

[2] Following the Series A round, the firm has a $7.5 million premoney valuation and a $10 million postmoney valuation (i.e., $10 million = $2.5 million ÷ 25% ownership stake).

If Series A investors had negotiated full-ratchet AD in their term sheet, their 2.5 million shares would be repriced to the Series B round price, and their shares would double to 5.0 million shares (= 2.5 million Series A shares ÷ $0.50 Series B CP). In effect, the adjustment in the conversion price allows the Series A investors to "pay" the same price for their shares as the Series B investors.[3] Importantly, this pricing adjustment occurs regardless of how many shares are issued (or the amount of money raised) in the Series B round. Thus, a company seeking to issue a small number of shares in order to raise needed capital is forced to adjust the share ownership of all the preferred shareholders who held this right in previous round financings.

Note that, following completion of the Series B financing and the adjustment for full-ratchet AD, Series A investors' ownership percentage increases from 20.83% to 34.48%, and this increase occurs primarily at the expense of the firm's common shareholders. In addition, because the round prices and percentage-ownership stakes have changed, the company's postmoney values change from $6 million before application of full-ratchet AD (= 12 million total shares × $0.50 per share, or $1 million ÷ 16.67%) to $7.25 million after application of full-ratchet AD (= 14.5 million total shares × $0.50 per share, or $1 million ÷ 13.79%).

Weighted-average AD protection: WAAD is a more frequently encountered form of AD protection in early-stage deals. It is generally more favorable to the entrepreneur, who typically holds common shares. As shown in the formula below, WAAD adjusts the conversion price of the Series A preferred shares by considering both the amount and price of the dilutive round of financing in relation to the company's value at the end of the previous round. The new conversion price (*NCP*) of the preferred stock under WAAD is calculated as shown in **Table 2**:[4]

Table 2. Calculating *NCP*.

OS	Outstanding shares before Series B	*Value of "Old" Shares*
OCP	"Old" Series A conversion price	
SI_B	Shares issued in Series B	*Value of "New" Shares*
P_B	"New" Series B price	*= Amount Raised*

$NCP = [(OS \times OCP) + (SI_B \times P_B)] \div (OS + SI_B)$

NCP reflects the relative value of the shares owned by "old" (pre-Series B) shareholders and the "new" (Series B) shareholders. Prior to Series B, there were 10 million shares outstanding (= 7.5 million common shares + 2.5 million Series A shares), and each share was worth $1.00 per share ($P_A$, Series A price). The value of "new" shares is the amount of capital raised in the round ($1 million), which is equal to 2 million shares issued (SI_B) at $0.50 per share ($P_B$). The total of these values, $11 million, is distributed over the total outstanding shares after the Series B round is completed. Applying this formula to our investment, we find that:

NCP = [(10 million × $1.00 per share) + $1 million] ÷ (10 million + 2 million)
NCP = $0.917

The new conversion price of $0.917 implies that the Series A investors who bought in at $1.00 will be able to convert their preferred shares into 1.09 common shares (= $1.00 P_A ÷ $0.917 *NCP*), and thus their shares

[3] Note that no capital is returned to the investor as a result of a full-ratchet adjustment. Rather, this adjustment simply issues more shares to the Series A investor.

[4] The WAAD formula has several forms and will sometimes include, for AD protection purposes, the number of stock options outstanding. When options are taken into account, the protection is said to be "broad based," and when they are excluded, it is said to be "narrow based."

increase from 2.5 million to 2.726 million after the adjustment for WAAD (= 2.5 million shares × 1.09).[5] Compared with full-ratchet protection, which implied a CP of $0.50, or 2.00 shares of common per preferred upon conversion, Series A investors receive considerably fewer shares, and thus they are protected less from the effects of a down round. The effects of WAAD protection on the company's capitalization following the Series B round are shown in **Table 3**.

Table 3. The effect of WAAD protection.

Second-Round Capitalization—WAAD Protection				
	Conversion Price of Preferred Shares	**Shares Issued (in millions)**	**Common Shares after AD Conversion**	**Percentage of Company Owned**
Common shares		7.50	7.50	61.34%
Series A preferred shares	*$0.917*	2.50	2.73	22.30%
Series B preferred shares	*$0.50*	2.00	2.00	16.36%
Total shares		12.00	12.23	100.00%

Price-based AD protection is sometimes subject to a "pay-to-play" provision, which makes the application of certain protective provisions contingent on the preferred stockholders' purchasing at least their pro rata share in a new round.[6]

Table 4 summarizes the manner in which the AD terms may be negotiated to afford greater benefits to the parties involved. The examples offer a perspective on how the same term within the term sheet can be worded to shape the relative rights of each party.

Table 4. Range of AD terms.

Price-Based AD Protection Terms		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Full ratchet	Weighted average Pay-to-play provision	None (structural AD protection only)

Non-Price-Based Antidilution Protection Terms		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Unqualified right of first refusal on company issue or shareholder sales. Right terminates on qualified public offering (QPO).[7]	Must hold minimum number of preferred shares (e.g., 15%) in order to exercise right of first refusal on company issues. Right terminates on QPO.	Must hold minimum number of preferred shares (e.g., 25%) in order to exercise right of first refusal on company issues. Right terminates on initial public offering (IPO).

[5] One can also compute the new number of shares after the adjustment for WAAD as 2.5 million shares divided by $0.917 ($NCP \div P_A$).

[6] Note that pay-to-play provisions may also affect other rights, so that a failure to "play" in the next round may result in a loss of several protections (thereby creating what is often referred to as shadow preferred stock). A more severe version of pay-to-play forces conversion of the preferred stock into common stock upon a failure to "play" in the next round.

[7] A QPO is generally defined as an IPO that (1) is a firm commitment and an underwritten offer, (2) raises a specific amount of money, and (3) will be at a certain minimum price (e.g., three times the preferred stock's conversion price).

Liquidation Preference

The *liquidation preference* stipulates the amount of money that the preferred shareholders must be paid upon a liquidation, dissolution, or sale of the company prior to the distribution of any proceeds to the common shareholders. The liquidation preference is usually equal to the original amount of capital investors provided in a round. Liquidation preferences come in two forms, a conventional liquidation preference known as a "single-dip" preference, and a *participating preferred,* known as "double-dip" preference. Either of these forms and can be further adjusted to include a cap, multiple liquidation preferences, or warrant coverage.

Conventional Liquidation Preference (Single-Dip Preference)

Under a conventional liquidation preference, the preferred stockholder must choose between receiving the liquidation preference *or* converting to common stock in order to share pro rata in the exit proceeds. Recall our Series A investment of $2.5 million representing 25% of the ownership. In this example, Series A investors' liquidation preference is the original capital invested in the deal, or $2.5 million. If the company is later sold for $8 million, investors choose between receiving the greater of $2.5 million or $2.0 million, their pro rata share of the exit proceeds (= 25% × $8 million). In this case, the Series A investors exercise their liquidation preference and receive $2.5 million, leaving the remaining $5.5 million (= $8 million − $2.5 million) to be paid to the common shareholders. One can see from this example that the preferred shareholders receive value-preserving protection against the loss of capital through the liquidation preference.

If the value upon liquidation were higher—say, $20 million—then the preferred shareholders have no reason to exercise their liquidation preference and would instead convert their preferred shares to common shares, participate pro rata in the liquidation proceeds, and receive $4 million.

Participating Preferred (Double-Dip Preference)

A participating preferred removes the choice investors face under a conventional preference, and the preferred shareholders not only receive their liquidation preference (first dip), but also participate with the common stockholders on an "as-if-converted" basis (second dip).[8]

Consider the same Series A investment above, except that investors hold a participating rather than a conventional liquidation preference when the company is liquidated for $8 million. In this case, Series A investors receive $3.875 million (= $2.5 million + 1.375 million [25% of $5.5 million]), compared with $2.5 million under a conventional preference. As a result, the common shareholders receive a smaller amount of the proceeds, or $4.125 million.[9] Based on the same exit, Series A investors receive $1.375 million more of the proceeds and, on a percentage basis, in total a substantially higher percentage of the proceeds (48.4%) than they negotiated up front compared to a conventional preference. For this reason, if the investors in prior rounds negotiated participating preferences, it can become more difficult to raise new capital if the company is perceived to have little remaining equity to sell.

[8] The double-dip participation feature does not apply when the exit from the investment occurs via an IPO or otherwise-defined QPO—only when the exit is via a sale, merger, or liquidation event.

[9] Often, the participation feature will contain a cap so that the preferred stockholders stop participating once they have received a total amount equal to some multiple of the original purchase price (usually 1× to 3×). Suppose in the above example, Series A had a liquidation preference with a cap of 1.5×. In total, Series A can receive up to $3.75 million (= 1.5 × $2.5 million) of the exit proceeds. Because of the cap, they lose $0.10 million in proceeds, which will be paid to the common shareholders.

Assuming the investment and liquidation occurred one year apart, the participation feature raises investors' realized return to 55% ($3.875 million ÷ $2.5 million − 1) versus 0% under a conventional liquidation preference ($2.5 million ÷$2.5 million − 1). As a result, a participating feature enhances the investors' chances of meeting their targeted rates of return. The more investors fear a low-valued exit from the current round's valuation, the more likely they are to seek a participating preferred (see **Table 5**). This situation more frequently arises when the entrepreneur demands a higher premoney valuation, or the later an investor enters to provide funds, since a late entrance means less time for the company's value to grow ahead of an exit.

Table 5. Range of liquidation preferences.

Investor-Favorable Liquidation	Middle-of-the-Road Liquidation	Entrepreneur-Favorable Liquidation
Participating (original purchase price plus cumulative dividends, then share with common on as-if-converted basis)	Capped participating (e.g., once total equals 2×-to-3× original purchase price)	Simple preference (original purchase price plus dividends)

Dividends

Working hand in hand with the liquidation preference is the right of the preferred shareholders to an annual or quarterly dividend, to be paid in preference to the common or other preferred shareholders. Dividend rates between 6% and 8% are commonly observed, and this rate can be adjusted upward or downward based on the relative bargaining power of the parties. Such dividends are generally payable only at the discretion of the board of directors, and can be paid either in cash or stock (additional shares). Because it is uncommon for the board of an early-stage company to actually declare and pay a dividend (due to the cash-strapped nature of early-stage companies), some deals provide a mandatory dividend that accumulates regardless of the board's action (a *cumulative dividend*). Cumulative dividends are an obligation of the company regardless of its earnings or ability to pay. (See **Table 6** for dividend terms.)

The principal reason for a cumulative-dividend right is to raise, over time, the value of the preferred shareholder's preference upon liquidation. In effect, this allows investors to receive cash or a greater share of the proceeds at a time when cash is more readily available to the company. If investors do not achieve a high-valued sale or liquidation of the company, then adding cumulative dividends to the liquidation preference at least locks in a minimum rate of return for the investors.

Assuming Series A preferred shares hold 25% of the equity for $2.5 million, a cumulative dividend acting in concert with a conventional liquidation preference works as follows:

- Series A preferred shareholders have a right to an 8% annual cumulative dividend, payable in cash (1) when declared by the board of directors, (2) upon redemption, or (3) upon liquidation of the company.
- Series A investors have a liquidation preference equal to the original price paid for those shares *plus* any accrued or unpaid dividends.
- Assume three years later, the company is liquidated for $8 million.
- Series A investors exercise their liquidation preference and receive $2.5 million (original purchase price) plus three years of dividend payments worth $0.65 million (= $2.5 million × 1.08^3 − $2.5 million), for a total payout of $3.15 million.

- Because the preferred shareholders elected to exercise their liquidation preference, they receive an 8% internal rate of return (IRR) on their original investment.
- Common shareholders receive $4.85 million ($8 million − $3.15 million).

Had investors held a participating liquidation preference together with a cumulative dividend, their payout would consist of $3.15 million *plus* $1.21 million (= 25% of the remaining $4.85 million available to common shareholders), for a total payment of $4.36 million. In this case, the preferred shareholders' IRR improves to 20.4%, well above their minimum rate of return.

The investor and the entrepreneur will likely have different views as to the wisdom of offering a cumulative dividend and an increasing liquidation preference. Early-stage investors can argue that their funds are more valuable to the venture (the funds come at a critical time, they are used for value-added investment, and so forth), and therefore they should receive some sort of minimum return. From the entrepreneur's perspective, however, these provisions can create a situation where the interests of the common and preferred shareholders may not always be aligned. For example, a situation could arise in which the preferred shareholders push for a sale or liquidation of the company so that they can exit an investment in which they have lost faith. In such a situation, the preferred shareholders may push for a deal that would generate a slight positive return for them (owing to the cumulative-dividend preference) while the common shareholders would bear any and all loss.

Table 6. Range of dividend terms.

Investor-Favorable Terms	Middle-of-the-Road Terms	Entrepreneur-Favorable Terms
15% Cumulative	8% Noncumulative	No dividends (completely at board's discretion)

Control Rights

Control rights allow the investors to exercise overt control over key company decisions, which provides them critical influence over the company's direction and future development. Control rights can be obtained in two main ways—through board representation or through voting controls over certain actions (generally referred to as "protective provisions").

The most obvious way for the preferred stockholders to exercise control is have a right to designate members of the board of directors (see **Table 7**). The board of directors manages the company's business affairs and appoints officers to carry out daily operations. Shareholders elect directors, generally by a voting scheme of one share, one vote; however, a voting agreement can provide that certain shareholders elect a designated number of directors. Therefore, board control does not necessarily follow ownership percentages. Investors can negotiate a variety of types of board involvement, ranging from outright control, a seat on the board, or simply observation rights. Observation rights permit an investor representative to attend board meetings but do not permit voting. Furthermore, investor rights can be structured so that, as the company progresses and meets certain milestones, the number of investor representatives on the board may decrease. Conversely, the rights can be structured so that, if the company fails to meet milestones or otherwise breaches contract terms with regard to the preferred stock, the preferred shareholders may acquire the right to elect a majority of the board. It is worthwhile noting that directors owe fiduciary duties to the company and its shareholders, and these duties can create substantial legal liabilities. Therefore, investors may prefer to exercise control through protective provisions, which typically involve less concern for legal liabilities.

Protective provisions require a vote by the preferred shareholders before the company can take certain actions. The approval threshold for such a vote may range from a simple majority (preferred by entrepreneurs in order to facilitate certain actions, such as future financings) to a supermajority (preferred by investors in order to retain a high level of control over such actions). Often, these voting controls are subject to a percentage "floor." In other words, if the number of outstanding shares of preferred stock drops below a certain percentage (e.g., 25%), the voting controls would be extinguished. Actions that are subject to a vote generally include any changes to rights specifically designed to protect an investor's interest (e.g., those relating to dividends, liquidation, conversion, redemption, dilution, voting, the issuance of additional shares, and the structure of the board of directors). Investors will also want some control over any action in which they risk a loss of control, such as certain asset sales, mergers, and other types of consolidations or major changes in ownership.

Table 7. Range of board representation and protective provisions.

Investor-Favorable Board Representation	Middle-of-the-Road Board Representation	Entrepreneur-Favorable Board Representation
Elect majority of board	Elect a representative to board	Elect representative to act as board observer (no voting rights)

Investor-Favorable Protective Provisions (Voting Controls)	Middle-of-the-Road Protective Provisions (Voting Controls)	Entrepreneur-Favorable Protective Provisions (Voting Controls)
80% approval of preferred shareholders necessary for certain actions (exhaustive list)	Two-thirds approval of preferred shareholders necessary for certain actions (moderate list)	50% approval of preferred shareholders necessary for certain actions (short list)

Redemption

Redemption is the investor's right to force the company to redeem (buy back) the investor's stake at a specified time in the future (see **Table 8**).[10] The principal reason for the inclusion of this term is to provide investors with a known liquidity event in case the investment begins to perform poorly.

Entrepreneurs often feel threatened by this term because it may lead to conflicting incentives between the preferred and common shareholders. An early-stage company still trying to stabilize its operations could find itself approaching a redemption deadline without the requisite cash to both redeem the preferred stock and continue operations. In an effort to prevent redemption and possible bankruptcy, the company's board could find itself contemplating a liquidity event that would not be in the best interests of the company and the common shareholders.[11] Furthermore, redemption rights may serve to block future financings, as potential investors might fear that their funds would simply be used to pay for the redemption.

Those facts notwithstanding, investors are clearly advantaged if they are able to negotiate a right of redemption.[12] Similar to a bond covenant, such a provision gives the investor greater bargaining power at a

[10] Note that the entrepreneur may, in conjunction with granting redemption rights to an investor, request similar rights for the company (so that the company has the right, on a specific date, to force the investor to sell back its stock—in effect, a call right).

[11] Another reason entrepreneurs dislike this provision is that banks tend to treat preferred stock with redemption rights as debt (which can affect lending relationships).

[12] It is important to note that, although the right may lose its practical advantage if the company has no money to redeem, it may provide an important bargaining chip in a future round (i.e., a "down round") of financing.

critical point in time in terms of fulfilling their return expectations to investors. When a redemption right is granted, the parameters of the right are usually constrained in some way, such as making the right exercisable only after some period of time (e.g., six or seven years) or conditioning the redemption on the approval of a percentage (e.g., 80%) of the preferred shareholders. A further condition might allow that the redemption payment be spread over two or three years in order to soften the deleterious effects of redemption on the company's cash flow.

The price at which the stock will be redeemed is usually either the fair-market value of the stock (as determined by a mutually agreed-upon appraiser) or the original price of the stock (or some multiple thereof) plus unpaid dividends.

Table 8. Range of redemption preferences.

Investor-Favorable Redemption	Middle-of-the-Road Redemption	Entrepreneur-Favorable Redemption
Majority vote of preferred shareholders required to force redemption	Two-thirds vote	No provision
One-third redeemed at year 3 One-third redeemed at year 4 One-third redeemed at year 5	One-third at year 5 One-third at year 6 One-third at year 7	
Price = 3× original purchase price plus dividends	Price = original purchase price plus dividends	

Frequency of Legal Terms and Investment Climate

The overall investment climate for early-stage funding can shift investors' negotiating and bargaining positions vis-à-vis entrepreneurs seeking funding. Investors will seek to negotiate different terms depending on their outlook for how likely an exit is to occur and their overall optimism about valuation. Some common metrics used to judge the optimism that investors hold for early-stage investments are the overall strength of the equity markets, the number of IPOs by venture-backed companies, the amount of venture capital funding companies have raised, the step up or price change in valuations between funding rounds, and the percentage of up and down rounds. **Exhibit 1** shows several of these commonly used valuation metrics along with trends in the frequency of usage of legal terms from 2008 to 2014. Lehman Brothers' bankruptcy occurred late in the third quarter of 2008, and in the ensuing two quarters one observes, compared to later periods, a precipitous decline in the returns on NASDAQ and a higher frequency of down rounds. The more bearish outlook with respect to the cash realizations that might be realized from early-stage investments results in a higher frequency of full-ratchet AD, participating preferred liquidation preferences, and redemption terms. As the overall climate and market conditions have improved in the years since, however, investors negotiate these terms less frequently. This suggests that as market conditions grow stronger and the outlook for early-stage investment becomes more optimistic, investors seek these more onerous protections less frequently or entrepreneurs gain greater bargaining power and have more ability to resist such terms.

Also note that even in the most difficult market conditions that followed Lehman Brothers' bankruptcy, full-ratchet AD, cumulative dividends, and redemption are used only in a small fraction of deals. This suggests that entrepreneurs resist funding that comes with these more onerous terms or that investors generally avoid these terms because they could compromise future fundraising efforts.

Conclusions

This note has outlined the effect of key terms of an early-stage term sheet on the parties involved in the deal, the value of the investment, and presented a range of alternatives for each term. That said, whether the terms of the preferred stock for a particular deal turn out to be investor-friendly or entrepreneur-friendly depends in large part on market conditions and the strength of the two parties' bargaining powers. Factors that can influence each party's relative bargaining power include how critically the funds are needed, how well the company is doing, how many other potential investors are interested, the number of similar investments available, and a particular investor's risk and return goals. It is important to use bargaining power wisely and to focus on those terms that have the greatest capacity to make a material difference in the returns and outcomes for the parties. The old adage about choosing one's battles carefully is a good guide for negotiating the terms of an early-stage investment.

Exhibit 1

Early-Stage Term Sheets

Frequency of Usage of Legal Terms

	Q4, '08	Q1, '09	Q4, '09	Q4, '10	Q4, '11	Q4, '12	Q4, '13	Q4, '14
	Lehman Brothers' Bankruptcy							
Valuation								
Qtr-over-Qtr Return, NASDAQ	−25%	−3%	7%	12%	8%	−3%	11%	5%
Last-12-Months Return, NASDAQ	−41%	−33%	44%	17%	−2%	16%	38%	13%
Up Rounds	**54%**	**25%**	**47%**	**67%**	**70%**	**71%**	**71%**	**79%**
Down Rounds	**33%**	**46%**	**30%**	**21%**	**16%**	**8%**	**16%**	**15%**
Flat Rounds	13%	29%	23%	12%	14%	21%	13%	6%
Antidilution								
Weighted-Average AD	**98%**	**97%**	**94%**	**95%**	**97%**	**95%**	**97%**	**99%**
Full-Ratchet AD	**2%**	**3%**	**6%**	**3%**	**3%**	**2%**	**1%**	**1%**
None	0%	0%	0%	2%	0%	3%	2%	0%
Participating Liquidation Preference	57%	51%	51%	45%	31%	40%	31%	20%
Cumulative Dividends	4%	10%	4%	5%	4%	6%	5%	5%
Redemption	23%	24%	21%	19%	9%	17%	10%	13%

Sources: NASDAQ composite returns are note writer calculations from month-end index values from Yahoo! Finance; data on deal terms are from Fenwick & West Silicon Valley Venture Capital Terms Survey Report, various quarters; the survey is based on the number of companies located in Silicon Valley that raised financing in that quarter.

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