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TEN THINGS TO KNOW

Series A Term Sheet Negotiations

Receiving a term sheet from a venture capital fund is a milestone that most founders dream of, but few get to experience. While it's certainly an exciting experience, it's also the tip of the iceberg when it comes to the fundraising process.

At Atrium, we've helped clients raise approximately $1B in over 100 equity financings and reviewed hundreds of term sheets along the way. With that in mind, we've taken some of the key provisions of a standard Series A term sheet and broken them down here, with explanations as to what they mean, what we typically see, and what to watch out for.

OPTION POOL

Term sheets usually call for a percentage of the Company's post-money capitalization to be included in the pre-money valuation and available to grant to service providers. By including the available option pool in the pre-money valuation, only the stockholders of the Company before the financing (e.g., the founders) are diluted by the increase of the pool in conjunction with the financing.

Typically, we see the available pool set at 10% in the term sheet, but this can vary based upon a number of factors including how long the amount being raised in the financing is intended to last the Company and how much hiring the Company anticipates post-closing of the financing.

The two main issues we see regarding the available option pool are (1) the investor asking for too high of an available option pool and (2) the effect of raising less than a fully-committed round.

If a term sheet calls for too high of an available option pool, the founders and early stockholders are diluted more than necessary.

If the Company does not raise the full round, the available option pool will be greater than the percentage called for in the term sheet. Because the number of available shares that equals the agreed upon percentage in the term sheet is calculated and implemented prior to the initial closing of the round and based upon the assumption of a full raise, if the Company raises less than a full round, there will still be the same number of available shares in the pool, but the denominator (the fully-diluted capitalization of the Company) will be less, resulting in a larger available pool on a percentage basis. For example, if the Company signs a term sheet to raise a $5M round on $20M pre-money valuation and the term sheet calls for a 10% available option pool post-closing but the Company ends up only raising $4M, then the available option pool would end up being 10.42% because while the total number of options in the pool stays the same, the fully-diluted capitalization decreases because of the lower amount raised.

LIQUIDATION PREFERENCE

A liquidation preference is the right of the investors (i.e., the preferred stockholders) to receive a specified amount of money, expressed in terms of a multiple of the original amount they invested, before common stockholders (e.g., founders and employees) in the event of a sale or other liquidation event.

1x non-participating is the norm in early-stage venture capital financings.

The “1x” is the liquidation preference multiple. This determines the amount of the investors’ original investment that must be returned before the common stockholders receive any portion of the liquidation proceeds. For a 1x liquidation preference multiple, the investors must get their original investment (or more technically, one times their original investment) back before the common stockholders receive anything in a liquidation event.

Non-participating means the investors receive the greater of (1) the liquidation preference amount or (2) the amount they would receive if they converted their preferred stock to common stock (in other words sharing pro rata with common stockholders). Non-participating liquidation preference is a downside protection – in the case of a successful exit, the investors will choose to share the liquidation proceeds pro rata with the common stockholders, but in a downside scenario, the investors will receive their original investment amount.

Participating preferred means the investors receive the liquidation preference amount and then share pro rata with common stockholders; think of this as double dipping.

Sometimes participating preferred will be subject to a cap. This means that the investors receive the liquidation preference amount and then share pro rata with common stockholders up to an agreed upon cap, which, like the liquidation preference multiple, is typically a multiple of the investors' original investment. After the cap is reached, the investors will stop sharing in the distribution of the liquidation proceeds to the common stockholders.

Participating preferred is uncommon in Silicon Valley.

"MAJOR INVESTOR" RIGHTS

Term sheets often define a subset of the investors as "major investors", who receive certain additional rights, beyond the rights, preferences, and privileges to which the preferred stock generally is entitled.

Major investor rights typically include pro rata rights (also known as a right of first offer or participation right) and information rights. Occasionally, term sheets will limit other rights, such as the right of first refusal and co-sale rights, to major investors. As for the threshold to qualify as a major investor, typically, the lead investor and any other significant investors who are listed by name in the term sheet will be major investors.

Be on the lookout for a major investor threshold that is set too low. The result is that more investors receive major investor rights (pro rata rights, information rights, etc.) and negotiations in future financing rounds with existing investors will be more complex.

DIVIDENDS

A dividend is a distribution, usually in cash, from the Company out of its profits to stockholders. For early-stage startups, declaring or paying dividends is rare because of the dependence on profitability and a desire to invest excess cash in the business to fuel growth and product development. However, that doesn't prevent investors from negotiating dividends in Series A term sheets.

Most commonly, we see dividends for Series A Preferred Stock structured as a when and as declared by the board dividend. This means that when a dividend is declared on the Common Stock, the Series A Preferred Stock receives the same dividend as the Common Stock.

Occasionally we see a term sheet that calls for a stated dividend prior and in preference to the Common Stock dividend. A stated dividend, it's typically expressed as a percentage of the class or series of preferred stock's original issue price, usually 6-8%. A stated dividend that is prior and in preference to the Common Stock dividend means that the Preferred Stock gets the stated dividend before the Common Stock and then also gets the Common Stock dividend declared by the Board.

One thing to watch out for when it comes to dividends are accruing dividends. Accruing dividends are stated dividends that accrue every year, regardless of whether declared by the Board. Once the Board does declare a dividend, it has to pay all of the accrued dividends to the preferred holders before any dividends can be paid to the Common Stock. Accruing dividends also add to the liquidation stack, meaning, in the event of an exit, these would be paid along with the liquidation preference.

BOARD OF DIRECTORS

At a high level, the Company's Board of Directors is responsible for the management and oversight of the Company, this includes strategic planning, hiring and firing executives, and making other key decisions for the Company, while day-to-day operational decisions are left to the officers and executives. For most early-stage startups, rather than have formal, regularly scheduled board meetings, the initial board (usually the founders) make decisions as needed and document such decisions as actions by unanimous written consent.

At the Series A stage, investors may push the Company to implement a board structure that is neutral to investor favorable. However, in our experience, founders typically retain control of the board, with the lead investor having the ability to designate one board seat and any term sheet that has the founders losing control of the board at the Series A stage (or earlier) should be approached with caution.

PROTECTIVE PROVISIONS

Protective provisions are a negotiated set of actions that the Company cannot take without the consent of the holders of a certain percentage (usually a simple majority) of shares of Series A. The actions restricted by the protective provisions typically include those that could negatively impact the Series A (increasing the number of shares of Series A, amending the Charter or Bylaws in a manner adverse to the Series A, etc.) or significantly impact the Company (incur substantial indebtedness, liquidation or other change of control transaction, etc.).

Depending on how much of the round the lead investor is taking and the dollar amount of convertible securities (e.g., SAFEs and/or convertible notes) that are converting into the round, the lead investor may negotiate for a higher threshold than a simple majority. It is helpful to have an accurate pro forma capitalization table when negotiating the term sheet as this will allow the Company to determine which investors are needed in order to take an action covered by the protective provisions.

FOUNDER REVESTING

If founder stock is not already subject to vesting restrictions, it probably should be.

In the beginning of a startup's lifecycle, it's uncomfortable to think about a potential founder termination, but it's far easier to tackle at the outset, than to wait until a founder is terminated or quits, at which point the relationship has probably deteriorated.

While we probably see it in fewer than half of the Series A financings we work on, it's not uncommon for investors to request that the founders subject some or all of their vested equity to new vesting restrictions. This applies even in the case of founders that have been working on the Company for several years and have fully-vested shares. From the investor's perspective, the additional vesting restrictions serve to keep the founders engaged and incentivized to continue growing the Company post-Series A closing.

Founder revesting should not be a full revest of all shares beginning at the initial closing, rather it's important to give consideration to a variety of factors when negotiating revesting, such as how long the Company has been operating, how long the founders have been working on the company, where the Company is in its lifecycle, etc.

COUNSEL EXPENSES

One of the oddities in raising venture capital dollars is that, in addition to the Company's own legal fees, it usually has to pay the legal fees for the lead investor in financing. In the context of a several million dollar Series A round, it is not a huge expense, however for smaller rounds the legal fee reimbursement could be burdensome.

It is always advisable to cap the amount of the lead investor's legal fees that the Company will be required to reimburse. We typically see investor counsel fee reimbursement in Series A financings ranging from $20,000 to $35,000, depending on the size of the round, operating history, who will be drafting, etc.

If a term sheet has a provision for reimbursement of legal fees in excess of range cited above, it's probably worth pushing back.

EXCLUSIVITY PERIOD

Once a term sheet is signed, there's usually a period of time during which the Company cannot solicit investments from others. This is known as the exclusivity period or a no-shop agreement. The investor has dedicated time and resources to get to a point where their ready to commit to investing in the Company; they don't want the Company to use their term sheet to try to get a better deal.

A 30 day exclusivity period is standard. Occasionally we see 45 to 60 days. Anything longer than that, or an exclusivity period that isn't limited by time is a red flag.

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FOUNDER LIQUIDITY

Given the length of time companies stay private and the high cost of living in areas like San Francisco and New York, founders might wish to sell a portion of their shares prior to or in connection with an equity financing round. Prior to raising a priced equity financing, the process for a founder to sell some of his or her shares is relatively straightforward: in most cases a founder can sell a portion of his or her vested shares if he or she first offers to sell them to the Company on the same terms (assuming the Company has a right of first refusal); if the Company elects not to purchase those shares, the founder can sell them to another buyer.

After raising a priced equity financing, the process is slightly more complicated because as part of the financing process the Company, the founders, and the investors likely entered into a Right of First Refusal and Co-Sale Agreement (a “ROFR Agreement”). Typically, the ROFR Agreement gives the Company a right of first refusal on any shares that a founder wishes to sell and provides the investors with a secondary refusal right (the right to purchase those same shares if the Company does not exercise its right of first refusal). Additionally, the investors will typically have a co-sale right. Sometimes called a tag along right, the co-sale right provides the investors with the right to sell a pro rata portion of their shares in lieu of the shares the founder wishes to sell.

One standard workaround to these increased hurdles is to carve out a percentage of the founders’ holdings that can be sold outside of restrictions imposed by the ROFR Agreement. In the majority of the Series A financings we’ve worked on at Atrium, the founders have had the ability to sell a portion of their shares (commonly 5%) free of the restrictions imposed by the ROFR Agreement.

CONCLUSION

By no means is this intended to be a comprehensive overview of equity term sheets. Rather, we hope that by leveraging our experience from reviewing term sheets on a daily basis, we can provide your Company with some context to frame an initial review of any term sheets you receive. Of course, it’s always a good idea to loop in Company counsel as early in the process as possible.

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