DLA PIPER

Venture Capital Academy - Part 1

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Term Sheet

Prior to a venture capital investment, the investor and the founder normally negotiate the main terms of the investment in a "term sheet". A term sheet should be short and concise but cover the main commercial and legal terms of the investment. Although a term sheet is largely not legally binding, its agreed terms are usually followed as they are seen as more or less morally binding. A term sheet thus contributes to a smoother investment process as it clarifies the intention of the parties at an early stage and can thus prevent the parties from entering into negotiations on important points when they later define the specific details of the investment in the investment and shareholders' agreement. Below is a summary of some key provisions being negotiated between the parties involved.

1. Valuation and ownership

Valuation and ownership are two of the most important elements negotiated in a term sheet. Unlike in public companies, there is no explicit market value for the shares and therefore other valuation methods are required. It is in the interest of all parties to agree on the valuation and to know what ownership the parties will have in the company already at this stage. Usually, the ownership before and after the investment is presented in a special compilation, a so-called cap table, where all the company's securities (shares and options, etc.), who owns what and the size of each owner's holding in the company are presented.

2. Liquidation preference

A venture capital investor may propose that preference shares be issued in the investment round with a "liquidation preference". This is a key financial agreement that affects future investment rounds and a future sale of the company. The liquidation preference provides a priority right to the company's assets in case of liquidation, dividend and sale of the company and aims to protect investors against an overvaluation of the company. It is important to ensure that the liquidation preference is properly negotiated with a long-term perspective to avoid putting holders of ordinary shares in a weak position in a sale or in future investment rounds.

3. Anti-dilution (dilution protection)

As mentioned earlier, one of the most difficult aspects of investing in private companies is the valuation of the company. In order to protect investors from the consequences of an overvaluation, investment or shareholder agreements often contain a provision that if the company subsequently issues shares at a lower price than the investor has paid, the company must issue shares to the investor at par value or at a heavily discounted price. These provisions are called anti-dilution clauses and aim to compensate the investor in case he/she has overpaid (from the investor's perspective) for his/her shares by reducing the average price he/she has paid for all his/her shares. Since several methods can be used to calculate the number of new shares to be issued under anti-dilution clauses, and since such clauses often affect other shareholders, it is important to understand how this mechanism works and operates.

4. Board of directors

A venture capital investor will typically want a right to appoint at least one director to the company's board and, in some cases, the right to appoint additional observers to attend board meetings. The purpose of such rights is to allow the investor to monitor its investment while allowing the company to benefit from the knowledge and experience of such a director. Furthermore, the parties usually agree on how many directors the founder(s) may appoint and whether the parties may appoint one or more directors jointly.

5. Drag-along

A venture capital investor will usually ensure that there is a clause in the term sheet that sets out the overall terms of a "drag-along". Such a clause means that shareholders who own above a certain threshold and who want to sell their shares have a right to force other shareholders to sell their shares on essentially the same terms. It facilitates a sale of the company as it prevents minority shareholders from making such transactions more difficult and gaining unreasonable bargaining power given their ownership.

6. Majority requirement for certain decisions

Typically, the term sheet also contains a list of protective provisions that prevent the company from taking certain actions without the prior approval of a qualified majority, such as two out of three of the largest investors in the company. Although some such provisions are market-based, all of them (whether standard or not) should be carefully negotiated. Some examples of common provisions where qualified majority approval is required are amendments to the articles of association or to share rights, issuance of new shares or other securities (other than shares and options under incentive schemes), changes to the size of the option pool, sale of business, indebtedness, dividends, employment of executives and related party transactions with shareholders.

7. Lock-up and vesting

An investment in an early stage company is based on the expectation that the founders will remain as operators and owners of the company. A term sheet therefore usually contains the overall conditions regarding lock-up and leaver clauses aimed at giving the founders and other key personnel an incentive to continue working with the company. This in turn creates value for the shareholders. These provisions mean that the founders are not allowed to transfer their shares in the company for a certain period of time and that they are obliged to transfer all or part of their shares to the other shareholders if their employment ceases or if they stop being actively involved in the company. The price at which such shares should be transferred depends mainly on two factors. The first factor is whether the founder is a "good leaver" or a "bad leaver", and the second factor is the length of time that has elapsed since the restrictions on these shares were imposed as the portion of the shares to be transferred normally decreases over time in accordance with a vesting schedule. In addition to the length of a vesting schedule, it is important for the parties to understand and often negotiate what happens in case of termination of employment, sale of the company, etc.

8. Option pool

The investor and the founder will usually want to agree with the company on how much of the company's share capital will constitute the company's option pool. The market size of the option pool is usually 5 - 15% of the company's share capital on a fully diluted basis and usually consists of warrants and/or qualified employee options.

9) Pre-emption right

A venture capital investor usually wants to have a right to participate in future financing rounds on a pro rata basis in relation to its ownership of the company in order to maintain its percentage ownership. Usual exceptions to this right are, for example, when issuing securities under an incentive program or when acquiring a company where the purchase price consists of a new issue of shares.

Please contact Mikael Moreira, Magnus Oskarsson and Gabriel Liska for more information.

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