A FOUNDER'S GUIDE TO NEGOTIATING VC TERM SHEETS

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NELSON MULLINS

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FOREWORD

When I began my legal career in 2003, the median pre-money valuation for a high-tech company raising a Series A financing was around $10 Million and the company's legal fees for a Series A financing could be expected to exceed $50,000. A little more than twenty years later, the median pre-money valuation for a high-tech company raising a Series A financing is around $50 Million and the company's legal fees for a Series A financing rarely exceed $50,000. Even controlling for the size of the round, the cost to companies of early-stage venture capital financing has dramatically declined over the past two decades.

It is no coincidence that 2003 is also the year the National Venture Capital Association (NVCA) published its initial set of model legal documents for Series A financing transactions. Prior to 2003, every venture capital firm had its own preferred set of terms and every law firm representing venture capital firms had its own preferred set of legal documents. The NVCA's model legal documents – created by a group of venture capitalists, lawyers and other industry insiders – gave the venture capital industry in the United States a common standard against which the proposed terms of any financing could be easily evaluated. In the intervening years, the NVCA has regularly updated the model legal documents to reflect changes in the industry and the law. While every venture capital firm still has its own preferred set of terms, and every law firm has its own preferred set of legal documents, most now take as their starting point the NVCA's model legal documents. I believe it is not an exaggeration to say that the creation and frequent updating of the NVCA's model legal documents has been a significant factor in speeding up financing transactions, reducing transaction costs and making capital more accessible to founders.

If there is one downside to the development of widely accepted terms and model documents, it may be that making it easier to agree on terms means parties often do not spend enough time considering the effect of those terms in the particular situation. Early in my career a company that received a term sheet would carefully review every term in consultation with the company's counsel and might negotiate for weeks before signing the term sheet. Now, it is not uncommon for founders to sign term sheets without ever consulting a lawyer. This is bad for the founder because it gives investors a clear upper hand in negotiations, particularly if the founder is unfamiliar with standard terms and, more importantly, how the interplay between terms impacts how decisions will be made and how money will be split in an exit. It is also not good for investors because they often do not learn of the founder's concerns until after the lawyers have prepared the initial drafts of the definitive transaction documents, at which point the negotiations are often more fraught, more time consuming and, as a result, more expensive. My hope is that this pamphlet will not only help you better understand standard terms in a venture capital financing, but also help facilitate discussions between you and potential investors that will ultimately lead to understanding, if not consensus, and better outcomes for everyone.

In closing, I want to acknowledge the contributions of several people who helped make this pamphlet possible. For sharing their perspective on negotiating term sheets and specific terms, and allowing me to share them with you, I am deeply indebted to: Daniel Acheampong of Visible Hands; Kent Bennett of Bessemer Venture Partners; David Beisel of NextView Ventures; Caroline Casson of Vitalize Venture Capital; Tim Chae of 500 Global; Payal Divakaran of .406 Ventures; Richard Dulude of Underscore VC; Matt Fates of Innospark Ventures; Allison Lechnir of Hyde Park Venture Partners; Jason Mackey of Athenian Capital; Crystal McKellar of Aloft VC; Christopher Mirabile of Launchpad Venture Group; and Senofer Mendoza of Mendoza Ventures. For making introductions to several of the aforementioned investors and their support in numerous ways, I'm equally indebted to Bobbie Carlton of Innovation Women, Stephanie Roulic of Startup Boston, and Allison Byers and Lily Macomber of Scroobious. Finally, I am forever grateful to my friend and former VC Ready Law Group co-founder, Michael Cohen, who encouraged me to write a series of blog posts in 2010 that served as the foundation of this pamphlet.

OVERVIEW

While I strongly suggest you consult a knowledgeable lawyer before signing a term sheet, regardless of whether you do so you will benefit from having a solid understanding of standard terms for an early-stage venture capital financing. Taking as our starting point the most recent version of the model term sheet from the National Venture Capital Association (NVCA), which is attached at the end of this pamphlet and available at nvca.org, this pamphlet will help you better understand and evaluate almost any venture capital term sheet so you can make informed decisions that are best for you and your company. The NVCA's model term sheet is an ideal starting point for learning about standard terms for three reasons: (1) the model term sheet is comprehensive and detailed, including all the terms common to VC financing; (2) the model term sheet includes helpful annotations that discuss the rationale for certain terms and alternatives to the default provisions; and (3) the NVCA also publishes model legal documents that you can review to get a deeper understanding of each provision in the model term sheet. While the term sheet you receive from an investor may not include all the same provisions as the NVCA's model term sheet, or include them in the same order or with the same level of detail, it will likely include all or nearly all the same concepts.

The NVCA's model term sheet is divided into seven sections: (1) Offering Terms; (2) Charter;[1] (3) Stock Purchase Agreement; (4) Investors' Rights Agreement; (5) Right of First Refusal/Co-Sale Agreement; (6) Voting Agreement; and (7) Other Matters. Offering Terms covers basic facts about the financing, including the identity of the lead investor, the type of security being sold, the amount the company is looking to raise, the target date for completing the financing and the pre-money valuation. The next five sections summarize the key terms of the five principal financing documents that are part of the NVCA's model legal documents, which together give the investors a variety of contractual rights vis-à-vis the company and the company's other stockholders. The final section, Other Matters, addresses the vesting of stock held by the company's founder and the treatment of any previously issued preferred stock, and also includes the only section in the entire term sheet that is explicitly binding on the parties: the No-Shop/Confidentiality section, which requires that the company keep the term sheet confidential and also prohibits the company from seeking financing from another investor for a specified period of time. The organization of the term sheet into these seven sections makes logical sense and is very convenient for the lawyers tasked with drafting the definitive transaction documents, but it does not help a founder raising capital for the first time evaluate how the proposed terms will ultimately impact her. To help you better understand and evaluate a term sheet, this pamphlet groups the provisions of the NVCA's model term sheet into categories based on how they are inter-related.

THE INVESTOR'S TAKE

"Negotiating a term sheet is never just about the deal specifically, it's about the process around understanding where each of you is coming from and how you work together. You learn a lot about someone in a negotiation that will inform what you can likely expect for the years ahead; both good and bad. If your gut says there are red flags in the partnership, there likely are!"

– Richard Dulude, Underscore VC

[1] The "Charter" is a generic term for the document filed with the relevant government authority in order to establish the legal existence of a corporation.

Most of the key terms in in a typical venture capital financing can be categorized as what I refer to as Economic Terms or Control Terms: Economic Terms being those that determine who ultimately receives the money available for distribution when the company has an exit event, and Control Terms being those that determine who makes decisions for the company. Most of the negotiation between the investors and the founders – particularly at the term sheet stage – involves each party making tradeoffs among these terms. In the case of the NVCA's model term sheet, the relevant terms (in order of their appearance in the model term sheet) are as follows:

Economic Terms:

- Pre-Money Valuation
- Dividends
- Liquidation Preference
- Optional Conversion
- Anti-dilution Provisions
- Mandatory Conversion
- Pay-to-Play
- Redemption Rights
- Registration Rights
- Right to Participate Pro Rata in Future Rounds

Control Terms:

- Voting Rights
- Protective Provisions
- Management and Information Rights
- Matters Requiring Preferred Director Approval
- Right of First Refusal/Right of Co-Sale (Take-Me-Along)
- Board of Directors
- Drag Along
- Founders Stock

I categorize most of the remaining terms in the model term sheet as either Transaction Terms – which I define to include: the introductory paragraph to the model term sheet, all of the Offering Terms listed in the model term sheet other than the Pre-Money Valuation (which is included in Economic Terms); Representations and Warranties; Counsel and Expenses; No-Shop/Confidentiality; and Expiration – or Operational Terms – which I define to include: Non-Competition Agreements; Non-Disclosures, Non-Solicitation and Development Agreement; Board Matters; and Employee Stock Options.[2]

Our review of the NVCA's model term sheet will begin with the Transaction Terms, which provide important context for topics covered in the rest of the pamphlet. We then move to Economic Terms, followed by Control Terms, and finally Operational Terms. As you go through the pamphlet, I encourage you to refer back to the NVCA's model term sheet and to the relevant sections of the NVCA's model legal documents, which contain helpful annotations that will give you a better understanding of each term. For your convenience, each section of the pamphlet notes the page(s) in the NVCA's model term sheet where the corresponding term appears.

THE INVESTOR'S TAKE

"My general bias is for term sheets and deal documents to be based on the NVCA forms. The founders still have flexibility to negotiate the things they care about (economics and control), but using the standard documents with the standard terms eliminates uncertainty and also reduces the time spent negotiating finer points that the folks at the NVCA have already thought through in a very founder friendly (and VC-fair) manner."

– Crystal McKellar, Aloft VC

[2] There are a handful of terms in the NVCA's model term sheet covering specific legal issues only applicable in limited circumstances – notably compliance with the regulations of the Committee on Foreign Investment in the United States (CFIUS) – and which are therefore not discussed in this pamphlet. Be sure to consult your attorney if they apply to you.

PART I: TRANSACTION TERMS

In Part I, we will cover the provisions in the NVCA's model term sheet that describe the terms of the financing transaction itself – as opposed to the rights and obligations of the parties following the transaction. This includes the provisions in the Stock Purchase Agreement section of the model term sheet, and it is the Stock Purchase Agreement (SPA) where most of these terms ultimately appear in the definitive transaction documents. For the most part, the Transaction Terms have no bearing on the company or the investors beyond the completion of the transaction (called the "closing," which is when the investors actually pay for their shares), but they do impact the cost to the company of the transaction, the ability of the company or the investors to walk away from the deal, and the right of the company to seek financing from other investors.

Introductory Paragraph (page 1)[3]

The introductory paragraph in the NVCA's model term sheet makes clear that, for the most part, the term sheet does not create any legally binding obligations on the company or the investors to complete the financing. The footnotes to the model term sheet point out that courts in some jurisdictions (notably Delaware and New York) have concluded that a non-binding term sheet still creates a binding obligation on the parties to negotiate in good faith, but even in those jurisdictions the term sheet does not compel either party to do a deal in most circumstances (see the discussion of "Conditions to Closing" nearby). Among other things, this means the parties are not tied to the terms in the term sheet, so they can – and often do – renegotiate some of the terms after the term sheet is signed. With that said, the term sheet serves to anchor further discussions and any deviation from the term sheet must be justified by the party seeking to make a change. This occurs most often when the investors discover something during their due diligence that is unfavorable to the company, so it is in the company's best interest to seek to negotiate the best terms possible at the term sheet stage.

Note that the introductory paragraph excludes from the non-binding caveat the "No Shop/Confidentiality" provision, which we cover later in this Part I.

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Key Issue: Law governing the term sheet.

Importance: Moderate

Tip: Term sheets often provide that they are governed by the laws of the state where the investor is based. If this jurisdiction is inconvenient, you can propose Delaware or New York as "neutral" jurisdictions.

Offering Terms (pages 1-2)

The "Offering Terms" section of the NVCA's model term sheet covers basic facts about the financing, most of which are self-explanatory and not the subject of much negotiation, but it is still important to review them because they will give you a framework for understanding the transaction as a whole and there are a number of things to which founders should pay attention. Note that while the Pre-Money Valuation is contained in the Offering Terms section of the model term sheet, I recommend that in reviewing the term sheet you consider the Pre-Money Valuation in conjunction with the other Economic Terms after reviewing the Transaction Terms.

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Key Issue: Stage of Financing

Importance: Moderate

Tip: If you and a potential investor cannot agree on whether the financing is a Seed or Series A round may signal a deeper disagreement about the stage of the company's development and near term objectives.

[3] The Page numbers refer to page(s) of the NVCA's model term sheet.

Security. A venture capital financing will always involve the sale of "preferred stock," which conveys to preferred stockholders different (and generally superior) rights and preferences relative to those that common stock conveys to common stockholders (which will include the founders). The title of the preferred stock that will be sold to investors has no particular legal significance, but it can have a signaling effect that is important for both the current financing and future financings. If the security is Series A Preferred Stock, as in the model term sheet, it implies the company has achieved some level of product-market fit, has customers, and needs additional capital to scale. There is also an expectation that your next major financing, typically labelled a Series B financing, will come after the company has demonstrated significant growth, so not being able to demonstrate growth can be a red flag for potential investors. As a result, if you are not sure your business is ready to scale, you might be better off selling "Series Seed Preferred Stock," even if it means accepting a lower valuation and/or taking less money.

THE INVESTOR'S TAKE

"What series you have raised is a signal to other investors in future rounds. Many investors focus on a specific round. People in VC associate different series with a specific stage of progress as well. Don't try and get cute. Follow what is generally accepted and you will reduce risk of confusion in future."

– Matt Fates, Innospark Ventures

Conditions to Closing. Conditions to Closing are explicit conditions that must be met before one or both parties are contractually obligated to proceed with the transaction. These conditions primarily protect the investors by requiring the completion of certain tasks and/or the occurrence of certain events before the investors are obligated to fund. For instance, founders may be required to sign non-competition agreements or agree to vesting of their stock in the company (both of these conditions are covered in greater detail later in this pamphlet). If the term sheet is governed by the law of a state that imposes a duty to negotiate in good faith, the conditions to closing may give one party or the other sufficient justification to walk away from the deal. The conditions listed in the model term sheet are standard and usually not the subject of negotiation, but you should confirm any term sheet you receive does not contain conditions that may be difficult and/or costly to satisfy. Unusually burdensome conditions in a term sheet may signal the investor's concerns about the investment or lack of commitment to seeing it through.

Key Issue: Unusual Conditions to Closing

Importance: Moderate

Tip: Conditions to Closing can signal concerns an investor has about the company's business that could be an obstacle to completing a financing.

Amount Raised. The amount to be raised in a financing is necessarily very fact specific and therefore beyond the scope of this pamphlet, but there is sometimes negotiation around the minimum amount the company must raise and whether a portion of the investment will be conditioned on the company achieving certain milestones.

- A minimum is only included where the investor proffering the term sheet insists on the company raising capital from others on the same terms. Sometimes this is a way for the lead investor to create room for other investors it wants to cut in on the deal; sometimes it is a way of encouraging, or requiring, participation from the company's existing investors; and sometimes it is simply an attempt to ensure the company will raise sufficient capital to execute on its stated business plan. If you receive a term sheet with a minimum investment amount, you should inquire after the lead investor's goal in requiring a minimum and its expectations for the source of the additional funds. It is in the interest of both the company and the lead investor that the company be reasonably certain it is able to reach the minimum before the term sheet is signed.
- Investors may also insist on dividing their investment into tranches, and some tranches may be subject to the company achieving certain milestones often tied to product development or revenue growth. If milestones are included, you want each milestone, and the mechanism for determining if each milestone is achieved, to be clearly defined to avoid future disputes. For example, if a portion of the investment is based on achievement of a revenue target, you will want to clarify whether revenue is measured on a cash or accrual basis and what evidence the investor will require to verify the revenue. It is best to clarify these details in the term sheet so any disagreement can be identified and, if possible, resolved, before both parties begin to incur substantial legal fees.

Key Issue: Funding Milestones

Importance: High

Tip: If the term sheet includes a minimum or tranches, you should push to flesh out the details before signing the term sheet.

THE INVESTOR'S TAKE

"A capital raise should provide sufficient runway for 18-24 months of operations and for reaching several value-creating milestones. The target amount of the raise should be calculated based on the projected budget and burn for that period plus a buffer of ~20%. In recent years, higher valuations and aggressive investor appetites have led many companies to raise large rounds. In the 'reset' world, companies will likely raise less as they seek to manage dilution in light of lower valuations. In general, a conservative approach to round sizing is a good practice – as they say, 'more companies die of indigestion than of starvation."

– Payal Divakaran, .406 Ventures

Stock Purchase Agreement (pages 7-8)

In the NVCA's model legal documents, the Stock Purchase Agreement is where you will find the terms of the investment itself – i.e. those governing the actual purchase and sale of the company's securities. In the model term sheet, many of the provisions that end up in the SPA are covered in the Offering Terms already discussed above so there are only two others covered separately.

Representations and Warranties.

Representations and warranties (R&Ws) are statements about facts and circumstances that either exist at the time a contract is signed or are expected to exist in the future. In a typical venture financing, the company is expected to make R&Ws about everything from the company's capital structure to its ownership of relevant intellectual property and its compliance with applicable laws. If any of the R&Ws are later found to have been inaccurate, the investors may have a claim for damages against the company on the theory that they would have paid less, or perhaps not invested at all, if they had accurate information at the time of the Closing. Investors also make R&Ws to the company – confirming their eligibility to participate in the offering (usually this means confirming they are "accredited investors"[4]) – though these R&Ws are not typically mentioned in the term sheet. While relying on R&Ws creates some post-closing risk for both parties, it also helps to speed up the transaction and reduce the transaction costs by allocating the risk to the party in a better position to verify the accuracy of the statement so the other party does not have to conduct as much due diligence before consummating the transaction.

Because the company's R&Ws are typically the basis for investors to claim damages if they believe they were misled, the R&Ws in the SPA are typically heavily negotiated. Investors push the company to make broad and unqualified R&Ws about its business, while the company seeks to narrow the scope of those R&Ws wherever possible. The NVCA's model SPA provides a helpful (albeit investor favorable) starting point for these negotiations, but because R&Ws are heavily fact dependent there is necessarily considerable tailoring required in each transaction. Much of this tailoring comes as a result of the investor's due diligence, so at the term sheet stage the only thing typically negotiated is whether and to what extent the company's founders will be required to personally stand behind the R&Ws about the company and its business.

The current iteration of the NVCA's model term sheet does not include R&Ws by the founders, even as an optional provision, but they still turn up often in initial term sheets. The rationale for including founder R&Ws is two-fold: (1) the founders know the most about the company and are therefore in the best position to verify the accuracy of the R&Ws; and (2) if any of the R&Ws turn out not to be accurate, the investors cannot be made whole if damages are paid by the company because such payment would also reduce the value of the company itself, and therefore of the investors' shares; whereas payment directly from the founders does not impact the value of the company. Founders' R&Ws are most common in a company's initial institutional financing, particularly if the founders are receiving some liquidity in the transaction. When founders' R&Ws are included in a financing, there are several ways in which the founder R&Ws, and the founders' potential liability for breaches of R&Ws, can be limited; including by: (a) limiting the subjects about which the founders are required to make R&Ws, (b) providing that the R&Ws do not survive (i.e. cannot be enforced) after a certain date (typically 6-24 months after the financing) or (c) capping the founders' liability (often at an amount no greater than the value of the founders' ownership interest in the company). The appropriate type and scope of the limitations is closely tied to the language of the R&Ws negotiated by the lawyers when preparing the SPA.

Key Issue: Inclusion of Founders' R&W's

Importance: High

Tip: Unless founders are taking money off the table in the financing, founders' representations and warranties should be very limited and ideally excluded entirely.

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[4] "Accredited investor" means an investor that meets certain financial or business sophistication criteria established by the U.S. Securities and Exchange Commission.

Counsel and Expenses. A company's largest expense when raising capital is legal fees. In addition to the company's own legal fees, in a Series A financing (though not as often in a Seed-stage financing) it is typical for the company to also pay some or all of the investors' legal fees.[5] As a result, while typical legal fees for raising capital have declined steeply (in real terms) over the past 20 years, they can still amount to a significant percentage of the funds raised in a smaller offering. The NVCA's model term sheet provides that if the financing closes the company will be responsible for payment of all legal and administrative expenses and responsible for reimbursing the investors for reasonable fees and expenses of their counsel. The model term sheet is a bit ambiguous as to whether the company is obligated to reimburse the investors for legal and administrative costs (but not legal fees) the investors incur even if the financing does not close, but requiring this of a company is highly unusual in an early stage financing – if for no other reason than that if the transaction does not close the company typically does not have money to pay its own expenses, let alone those of an investor. As indicated in the model Term Sheet, the other way companies often seek to limit their responsibility for investors' legal fees is by placing a cap on the dollar amount of the fees the company is required to reimburse. These days, the cap is typically $35,000-$50,000.

It is also worth noting that the model term sheet assumes the company's counsel, rather than the investor's legal counsel, will prepare initial drafts of the transaction documents. This runs contrary to conventional wisdom that counsel to the party bringing the most money to the table prepares the initial drafts of the transaction documents. This is because any advantage generally conferred by drafting is significantly diminished where, as in a Series A financing governed by the terms of the NVCA's model legal documents, the range of terms is fairly well understood and accepted. This is not necessarily the case for transactions in which the NVCA's model legal documents are not used as the starting point for the definitive transaction documents, so it is often the case that term sheets allocating the drafting to the company's counsel will also specify that the definitive documents will be based on the NVCA's model legal documents. If the investors insist that their counsel prepare the initial drafts of the financing documents, it is generally not worth arguing unless you believe it would be significantly more cost effective to have your lawyers draft the documents. You should, however, try to include in the term sheet the NVCA's model legal documents will be the basis for the definitive deal documents as using the NVCA forms will typically reduce the cost of reviewing and revising the drafts.

Key Issue: Obligation to pay Investors' legal fees

Importance: Moderate

Tip: The Company's obligation to pay legal fees for the investors' counsel should always be capped and contingent on the deal closing.

THE INVESTOR'S TAKE

"As the earliest and eventual lowest in the preferred capital stack, philosophically we endeavor to keep things as plain-vanilla as possible because we've found that when bells & whistles are added early, they tend to multiply."

– David Beisel, NextView Ventures

[5] Legal fees depend a lot on the specific facts and circumstances of a transaction. For a Series A financing, I recommend budgeting $20,000-$75,000 per side, keeping in mind that the company will usually be paying the fees for both sides if the deal closes.

No Shop and Confidentiality (page 15)

Earlier, I noted that the No Shop/Confidentiality section of the model term sheet is the only section that is usually "binding" on the company and the investors – meaning it is enforceable even if the rest of the contemplated financing is never completed. The "No Shop" provision requires that the company refrain from actively pursuing any other investment or any sale of the company for a set period of time after the term sheet is signed. The "Confidentiality" provision prohibits the company from disclosing the terms of the term sheet, except on a need-to-know basis. Most of the time the only point of negotiation is the length of the No Shop period. This ranges from 30 to 90 days, but in my experience is typically 45 or 60 days. Once the term sheet is signed, both sides are usually anxious to get the transaction closed as quickly as possible.

Term sheets sometimes provide that the company must pay the investors a break-up fee in the event the No Shop provision is breached. Including such a fee is uncommon and generally only used in later-stage financings.

Key Issue: Length of No Shop

Importance: Moderate

Tip: Try to keep the No Shop to no more than 60 days and do not agree to a breakup fee.

THE INVESTOR'S TAKE

"Don't rush into signing a term sheet without thoroughly understanding its implications. Negotiating terms is more challenging and expensive once the term sheet is finalized."

– Jason Mackey, Athenian Capital

Expiration (page 15)

Like most term sheets, the NVCA's model term sheet includes a stated expiration date. This can give first time founders a sense that the investor will vaporize if the term sheet is not signed by the date indicated, and they may feel pressure to sign a term sheet with which they are not entirely comfortable or, worse yet, have not fully reviewed and digested. Speaking from personal experience, I have never seen a company lose a potential investor because it did not sign the term sheet by the expiration date. The purpose of setting an expiration date is to give the investor a legal right to walk away, but as I have already noted a term sheet typically includes other terms that give the investor an out if circumstances change. Rather than viewing the expiration date as a drop dead date for accepting the terms proposed by the investor, I recommend you treat the expiration date as the date by which you should revert back to the investor with your initial thoughts on the term sheet, if not a counterproposal.

Key Issue: Expiration Date

Importance: Low

Tip: The expiration date is almost never a hard deadline.

PART II: ECONOMIC TERMS

After reviewing the Transaction Terms, I recommend moving to a review of the Economic Terms in the term sheet to understand how the financing will ultimately impact your ownership interest in the company and your right to a share of any proceeds in an exit. To understand how the Economic Terms interact, it is usually helpful to create a spreadsheet to model out different exit scenarios so you can see how changing different terms impacts the ultimate outcome.

Pre-Money Valuation (page 2)

The pre-money valuation is the first term every founder focuses on when reviewing a term sheet, and with good reason. Not only does the valuation directly impact the portion of the company the investors will end up owning (and the resulting dilution to the founders and other existing stockholders), but it is also used by third parties (including the media) as a proxy for the company's development, particularly vis-à-vis its competitors. While the headline number is obviously important and often the focus of heated discussion between the founders and the investors, how the valuation is calculated, and specifically what is included in the pre-money capitalization of the company used to determine the valuation, ultimately determines how much of the company the investors are buying in the transaction.

THE INVESTOR'S TAKE

"A conversation about the right size of the option pool can either be a conversation about the equity compensation strategy and how to get it right OR a sneaky way to continue to negotiate valuation. In good working relationships it should be the former – use the pre-money valuation to negotiate the company value and use the option pool to set aside an appropriate option budget so that the company can hire and execute on goals to the next fundraising milestone."

– Kent Bennett, Bessemer Venture Partners

THE INVESTOR'S TAKE

"There are two primary metrics to consider when it comes to valuation: 1) Founders should expect to sell ~20% of the company with each round of funding. 2) Founders should examine relevant revenue multiples by looking up comparable transactions in their space. I typically see between 8x and 14x revenue multiples for software companies at the seed stage; however, multiples can vary widely by industry and company stage, and valuations can vary widely based on factors such as market conditions, growth rates, team experience, and more."

– Caroline Casson, Vitalize Venture Capital

The NVCA's model term sheet provides that the pre-money valuation is calculated assuming the company's "fully-diluted" capital includes an employee option pool.[6] The employee option pool is typically set at 10-20% of a company's fully-diluted post-money capitalization at the time of a Series A financing. The principal factor in determining the size of the pool should be the need to incentivize current and future employees, so a company with a strong core team already in place should not need as large a pool as a company that expects to hire a new CEO in the near future. If the pool seems large, your potential investor may have a different expectation than you do about the future growth of the company and you should raise this with the investor and try to come to a consensus as to how the size of the pool should be determined. The goal should be to establish a pool that is the right size to meet the company's needs for the foreseeable future.

Note that including a new option pool (or a proposed increase in an existing option pool) in the company's pre-money valuation results in an illusory increase in the pre-money valuation because it assumes shares reserved in the option pool will be issued prior to an exit. This is sometimes referred to as the "Option Pool Shuffle[7]." There is nothing inherently wrong with including an option pool in the pre-money valuation, but it is important for founders to understand that doing so has real economic impact. To illustrate, consider a pre-money valuation of $5 million that does not include an option pool and a pre-money valuation of $6 million that includes an option pool equal to 20% of the company's fully-diluted capital. In the latter case, the option pool accounts for $1.2 million of the valuation, making the effective pre-money valuation only $4.8 million.

Key Issue: Impact of option pool on dilution

Importance: High

Tip: Understanding how the option pool impacts the valuation is critical when evaluating a term sheet, and especially when comparing term sheets.

Liquidation Preference (page 3)

The Liquidation Preference is the most important Economic Term in a financing term sheet after the valuation because it establishes the relative rights of the preferred stockholders (i.e. the investors) and the common stockholders (i.e. everyone else) with respect to any assets available for distribution. In a sense, the Liquidation Preference puts the "preferred" in "preferred stock," because it establishes the right of the preferred stockholders to receive preferential distributions of the company's assets. It applies to a true liquidation in which the company shuts down its operations and dissolves, but more importantly it applies to any so-called "Deemed Liquidation Event," such as an acquisition by another company, which generates cash or other assets (ex. stock of the acquiring company).

The model term sheet includes three alternative provisions for the liquidation preference. In all three alternatives, preferred stockholders are entitled to receive a preferred return – typically some multiple of their original investment (1x-3x) plus any accrued and unpaid dividends (discussed below) – before any payment is made to the common stockholders. The most company favorable alternative – and by far the most common in Seed and Series A rounds – is non-participating preferred stock, which gives the investors the option of receiving the preference amount or the amount they would receive by converting their preferred stock to common stock (more on conversion below). The most investor favorable alternative – which is very rarely seen in Seed and Series A rounds – is fully participating preferred stock, which gives the investors the right to receive the preference amount and share with the common stockholders, on an as-converted-to-common basis, in the distribution of any remaining proceeds (this is generally referred to as "double dipping"). The third alternative, participating preferred stock with a cap, limits the aggregate amount of the investors' preferred return and by doing so increases the amount the company would have to receive in an exit (relative to if they owned non-participating preferred stock) before the investors would choose to forego their preference and convert to common stock.

[6] "Fully-diluted capital refers to the total number of shares of common stock of a company that would be outstanding after giving effect to all existing rights to acquire common stock (ex. through conversion of preferred stock or exercise of outstanding options). Fully-diluted capital often, but does not always, include shares reserved and still available for issuance under a company's option pool.

[7] For a more in-depth discussion of the impacts of the Option Pool Shuffle, see https://venturehacks.com/option-pool-shuffle.

It is very rare for investors to insist on participating preferred stock, or even a greater-than 1x liquidation preference, in a Seed or Series A financing, perhaps because they recognize that participating preferred reduces the founders' economic incentive to build the business and sets a precedent for later rounds that could leave earlier investors worse off. In the overwhelming majority of Seed and Series A financings, the investors ask for, and receive, a 1x non-participating liquidation preference. This is so common that it is rarely a point of discussion. In later rounds, particularly down rounds (discussed below) where the investors have more leverage, participating preferred and liquidation multiples are more common.

If you do receive a term sheet with participating preferred stock or a greater-than 1x liquidation preference, or both, it is a good idea to do some quick math to determine what different groups of stockholders (investors, founders, employees, etc.) would take home if the company were sold at different price points (for this exercise, assume the entire proceeds of the sale go to the stockholders). You should also consider how the distribution changes with different preferences and participation right, as well as with and without a cap on participation. It is important to try to be realistic about the company' potential exit value, and your goals for an exit, because it will impact how you negotiate the liquidation preference. Keep in mind that the participation aspect of participating preferred stock only comes into play if the proceeds generated from a sale of the company are enough to cover the liquidation preference and then some; if the proceeds are not enough to cover the liquidation preference the participation is irrelevant. On the other hand, a greater-than 1x liquidation preference increases the amount the company must receive in an exit before the founders and other common stockholders receive any proceeds at all, but if the proceeds are great enough the liquidation preference becomes irrelevant. Depending on your goals and expectations, you may be better off agreeing to give the investors 1x participating preferred stock instead of a 2.5x non-participating liquidation preference, or vice versa.

THE INVESTOR'S TAKE

"I don't believe participating preferred is appropriate for Seed or Series A rounds where the equity upside is what the investor is underwriting. Participating preferred may be appropriate in later rounds where a liquidity event is within sight and the participation allows the investor to underwrite the returns they need in an environment where equity upside isn't necessarily as visible."

– Tim Chae, 500 Startups

Key Issue: Economic impact of liquidation preference

Importance: High

Tip: Participation right and liquidation preferences of more than 1x are very rare in Seed and Series A deals, and a sign the investor is taking a very aggressive stance on terms.

Dividends (page 2)

Dividend provisions are often overlooked by founders but can significantly improve the investors' economics. The NVCA's model term sheet includes three alternative dividend provisions. The first would give the holders of preferred stock the right to receive the same dividends as the holders of common stock, on an as-converted basis (company favorable). The second would give the holders of preferred stock the right to receive separate dividends irrespective of dividends on the common stock, but only when and if declared by the company's Board of Directors (Board), which is rare. The third alternative would give holders of preferred stock the right to cumulative dividends that accrue at a specified rate in addition to sharing in any dividends payable to the holders of common stock (investor favorable). Like interest on a loan, accruing dividends may "compound" periodically, meaning dividends accrue on prior dividends that have not been paid, though this is rare. Due to both legal and practical limits on the ability of a company to pay dividends, even accruing dividends not requiring Board approval are rarely if ever actually paid out in cash unless and until the company liquidates (and then only if there is enough cash available, which there often is not). As noted in footnote 6 to the model term sheet, accruing dividends are sometimes converted to common stock if the underlying preferred stock converts. (for more about conversion, see "Conversion and Anti-Dilution" below).

The potential economic impact of dividends is most significant if the company is eventually sold for a modest amount that is neither a failure nor a home run. If a company is wildly successful, the value of the dividends relative to the overall returns to the stockholders will be trivial, and if a company fails there will not be any money to pay dividends. Between these extremes, however, dividends can take a significant bite out of a founder's payout when her company is sold. Since few companies become wildly successful, founders should try to eliminate accruing dividends, or at least reduce their effect by (a) keeping the dividend rate low (5-7% is typical in normal economic times), (b) insisting that the dividends do not compound and/or (c) providing that the dividends do not begin to accrue until sometime in the future (typically 1-3 years from the date of the financing).

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Key Issue: Economic impact of dividends

Importance: Moderate

Tip: The economic impact of accruing dividends can be significant and should be included when modeling out exist scenarios.

THE INVESTOR'S TAKE

"Sweeteners like accruing dividends become more common in down turns. We tend to avoid them because, like all terms used in early rounds, they become enlarged and magnified when later rounds ask for them. The one place we will use them is with a business that is unlikely to fail but could easily turn into a lifestyle business. If it has a high enough probability of a good outcome to be worth investing, but it has a chance of leveling off and going sideways (in other words, the management team are the only people getting paid), then we will sometimes add an accruing dividend because it puts a time clock on the founders. In effect, it shifts ownership from common to preferred."

– Christopher Mirabile, Launchpad Venture Group

Conversion and Anti-Dilution (pages 5-6)

Three sections of the model term sheet – Optional Conversion; Mandatory Conversion; and Anti-Dilution Provisions – determine when an investor's preferred stock may or must convert to common stock, and how many shares of common stock are issued when the preferred stock converts, which ultimately impacts the portion of the company the investors own.[8]

Optional Conversion and Mandatory Conversion. When initially issued, preferred stock is almost always convertible into common stock at a 1:1 ratio:

(a) at any time at the option of the preferred stockholder ("Optional Conversion"); or

(b) automatically (i) at the time of the company's initial public offering (IPO), usually subject to the public offering share price being at least X times the per share price paid by the investors, or (ii) if the holders of a majority (or sometimes super-majority) of the outstanding shares of preferred stock agree to convert all preferred stock held by all investors (both (i) and (ii) being examples of "Mandatory Conversion").

Having the option to convert is critical to investors in large part because, as noted in the discussion of "Liquidation Preference" above, at the time of a Deemed Liquidation Event the investors want the ability to convert their preferred stock to common stock if doing so would result in the investors receiving a larger payout. As a result, there is rarely any negotiation around Optional Conversion. While the Mandatory Conversion provision are also not typically hotly debated, it is helpful to understand the typical triggers.

- For a Mandatory Conversion upon an IPO, the threshold public offering price, if there is one, is typically set at 3X-5X the original purchase price. Because investor approval will always be required before an IPO (either explicitly or because of the amendments to the corporate charter required before the company goes public), in practice the threshold may matter less to the company than to the lead investor, who wants to be sure it will be able to compel smaller investors to convert. In any event, at the time of a Seed or Series A financing an IPO is so remote that the threshold does not matter because it will inevitably be adjusted in subsequent rounds.
- The percentage of preferred stock required to approve a forced Mandatory Conversion is typically the same as that required to approve other matters requiring separate approval of the investors (see the discussion of Protective Provisions below). If there is a single lead investor that will own a majority of the preferred stock, the company and the lead investor are usually in agreement that the threshold should be a simple majority. If there are co-lead investors, the threshold is typically set high enough that each investor has a veto on a forced conversion.

Key Issue: Threshold for forcing conversion

Importance: Low

Tip: To facilitate an eventual exit, it is better for the company if holders of a majority of preferred stock have the ability to force conversion of all preferred stock, and that the threshold to force conversion not be so high as to allow a small group of investors to block conversion.

[8] Ownership, of course, impacts both the investors' economic interest in the company and their voting power, so these three provisions could also be considered Control Terms. I categorize them as Economic Terms because preferred stock rarely converts to common stock before the company is acquired or goes public, so increases in the investors voting power resulting from changes to the conversion ratio have less impact on the balance of power because the investors have other means of exerting control.

Anti-dilution Provisions While the timing of conversion is not a very hot topic in negotiating a term sheet, the anti-dilution provision can be. The number of shares of preferred stock issuable upon conversion of common stock is determined by what is typically called the "conversion ratio," which is the ratio of the so-called "conversion price" of the preferred stock to the price at which the preferred stock was sold to the investor. Both the conversion price and the original issue price are initially equal – resulting in the 1:1 initial conversion ratio noted earlier – but the conversion price is typically subject to adjustment in a variety of circumstances that impact the company's overall capitalization. Some circumstances – such as stock splits, reverse stock splits or stock dividends – do not change the economics of the preferred stock and therefore the adjustment merely maintains the status quo. In other circumstances - notably when the company issues shares at an effective price-per-share lower than the price-per-share paid by the investors (a future financing at a lower price is called a "down round") – the adjustment compensates the holders of preferred stock for a reduction in the value of the preferred stock. These latter adjustments are referred to as "price-based" anti-dilution protection.

Price-based anti-dilution protection operates by decreasing the conversion price of preferred stock, thereby increasing the conversion ratio and, as a result, the number of shares of common stock into which a share of preferred stock converts. This means that in a down round the holders of common stock (who do not have anti-dilution protection) are effectively diluted twice by the issuance of the shares to the new stockholders and as a result of the adjustment to the conversion price of the preferred stock.

The current version of the NVCA's model term sheet includes a standard weighted average anti-dilution formula, which reduces the conversion price of outstanding preferred stock in proportion to the number of shares being issued and the price per share. The extent of the adjustment also depends on whether certain derivative securities (such as options and warrants) are included in the calculation of the company's existing capital. A broader formula, which may include not just derivative securities then outstanding but also shares of common stock already set aside by the company's Board for future option grants and similar awards, results in less of an adjustment (i.e., is more company favorable) than a narrower formula that may only include some derivative securities or even exclude them entirely. The NVCA's model term sheet takes a middle-of-the-road approach: for purposes of the anti-dilution calculation, the number of shares outstanding (the "A" variable in the formula) includes common stock issuable upon exercise of outstanding options (whether or not vested) but does not include shares of common stock that may be issued out of the company's available option pool.

Earlier versions of the NVCA's model term sheet included as an alternative a more investor-favorable form of anti-dilution provision, known as full ratchet anti-dilution, which adjusts the conversion price of outstanding preferred stock to that of the stock being sold in the new offering, regardless of the number of shares issued. This type of anti-dilution protection is extremely favorable to the investor and should be strongly resisted by the company in favor of weighted average anti-dilution. The fact that full ratchet anti-dilution no longer appears in the NVCA's model term sheet is a clear indication that it is considered off-market, so if you receive a term sheet with a full-ratchet anti-dilution provision it should be a red flag that the rest of the terms may be heavily investor favorable. While it is rare to see full-ratchet anti-dilution in a Seed or Series A financing, I have seen deals where investors agree to a higher valuation than they would have otherwise in exchange for full-ratchet anti-dilution protection. If you find yourself in a similar situation, the term sheet should make clear that the full-ratchet anti-dilution only survives until the next priced round and is then replaced with weighted average anti-dilution. Regardless of the type of anti-dilution protection, there are a number of standard exceptions allowing

a company to issue additional shares in specified circumstances without any adjustment to the conversion price of the outstanding preferred stock. The NVCA's model term sheet includes standard exceptions for (i) securities issuable upon conversion of outstanding preferred stock, or as a dividend or distribution on outstanding preferred stock; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) common stock issuable upon a stock split, stock dividend, or any subdivision of shares of common stock; and (iv) shares of common stock (or options to purchase shares of common stock) issued or issuable to employees or directors of, or consultants to, the company pursuant to any plan approved by the company's Board of Directors (approval of the plan by the holders of preferred stock is sometimes also required for the exception to apply).

Key Issue: Impact of anti-dilution in down rounds

Importance: High

Tip: Anti-dilution makes down rounds doubly dilutive, so if necessary it may be worth trading a lower pre-money valuation for more founder-friendly anti-dilution.

THE INVESTOR'S TAKE

"Full ratchet anti-dilution is usually a barrier to getting a clean subsequent round done. And most of the time, if the company is in doing well at the next round, the new investors would require replacing the full ratchet provision with weighted average anti-dilution."

– Tim Chae, 500 Startups

Redemption Rights (page 7)

Once commonplace, Redemption Rights are now often excluded from Series A term sheets (and rarely included in Series Seed term sheets) for reasons discussed below. We cover Redemption Rights in this pamphlet because they are still included in the model term sheet (albeit in brackets and with a footnote pointing out that they are rare), but they are more common in later rounds when investors may have a better rationale for insisting on Redemption Rights as a means to force an exit.

The Redemption Rights provision in the NVCA's model term sheet is fairly typical, providing that after five years the investors, as a group, would have the right to require the company to repurchase all of the outstanding shares of preferred stock at a price equal to the original price paid by the investors plus any accrued and unpaid dividends, if applicable. The redemption right can be either "optional" (as in the model term sheet) – in which case exercising the right requires approval of at least X% of the investors – or "mandatory" – in which case the redemption is required unless X% of the investors waive it; in either case the applicable percentage is usually the same as that required to approve actions covered by the Protective Provisions (discussed in Part II). Individual investors may be given the right to opt out of redemption, but they are not typically given the right to separately require redemption of their shares.

The problem for investors is that practical and legal constraints on the ability of the company to redeem shares (similar to limits on the company's ability to pay dividends discussed earlier) often preclude them from enforcing Redemption Rights in court. Because of this, investors may insist on alternative enforcement mechanisms or other springing rights if the Redemption Rights are exercised but the preferred stock is not redeemed. As noted in footnote 14 to the model term sheet, the investors may gain the right to elect a majority of the company's Board of Directors or approve certain company expenditures until all the investors' shares are redeemed. Alternatively, the investors could gain the right to interest on the unpaid redemption proceeds or the right to convert their preferred stock into common stock at discount to the then-current conversion ratio. In addition to giving the investors greater control and economics, these additional rights give the investors leverage to extract concessions from founders that may be reluctant to seek an exit.

A Series A investor should expect to wait close to a decade before realizing a return on her investment, so you should be cautious about accepting an investment from any potential Series A (or Series Seed) investor that is insisting on Redemption Rights exercisable after five years or so. If you are able to get comfortable that the investor would only exercise the rights as a last resort (ex. if the company is failing or has become ungovernable) and not as a means of forcing a liquidity event whenever it suits her, then your primary goal in negotiating the provision should be to limit – or better yet eliminate – any springing rights the investors would obtain if the Redemption Rights are exercised but the preferred stock is not redeemed. You can seek to minimize the impact of Redemption Rights by making it less likely they will be exercised – for instance, by pushing back the date the rights may be exercised or negotiating for optional redemption instead of mandatory redemption – and less painful if they are – for instance, by giving the company more time to complete the redemption.

Key Issue: Redemption Rights are rarely exercised

Importance: Low

Tip: Unless the term sheet specifies a consequence for failing to redeem shares, it is usually best to focus on improving other terms of the term sheet.

Registration Rights (pages 8-9)

Like Redemption Rights, Registration Rights give investors another means of forcing a liquidity event on the company. And like Redemption Rights, Registration Rights are rarely ever exercised but can give investors leverage to extract other concessions from the founders. Unlike Redemption Rights, Registration Rights are ubiquitous in Series A financing and commonplace in Series Seed Financing.

Registration Rights give the investors the right to require that the company register their shares with the Securities and Exchange Commission, which is a prerequisite to selling shares in the public markets (i.e. NYSE, Nasdaq, etc.). The NVCA's model term sheet includes the three types of registration rights typically requested by investors – Demand Registration; S-3 Registration; and Piggyback Registration – and also provides that the company will be responsible for any registration expenses (which can be significant), including at least a portion of the investors' legal fees. Of the three types of Registration Rights, Demand Registration is the most important because it effectively allows the investors to compel a company to conduct an initial public offering (IPO). S-3 Registration and Piggyback Registration only apply where the company has already registered, or already decided to register, some of its shares, so the exercise of those rights is much less of a burden on the company.

Taking a company public can be lucrative for both founders and investors, but the process of registering shares with the SEC, particularly the first time, is very costly and time-consuming, so investors have little to gain from compelling a company to do so before the company's business is ready or when market conditions are not favorable, even if the company is responsible for paying the registration expenses. While early-stage investors often insist on registration rights to ensure they will have a seat at the table if the company eventually goes public, because the prospect of going public is so remote at the time of a Series Seed or Series A financing, Registration Rights are rarely the subject of discussion when negotiating the term sheet. In a Series A financing, it is typical for the company to grant the full slate of Registration Rights to most or all the investors, but the details of those rights are usually left for the lawyers to negotiate when drafting the definitive transaction documents. In a Seed-Stage financing, investors often only require an agreement from the company that they will receive the same registration rights as those granted by the company in future rounds and may be willing to forego Registration Rights altogether.

If some of the details of the Registration Rights are included in a term sheet, as they are in the NVCA's model term sheet, the most important the issues are (1) the threshold percentage of investors having registration rights that is required to trigger Demand Registration (the percentage should be high enough to ensure the registration has the support of most of the investors), (2) the earliest date the investors may exercise Demand Registration rights (at least five years from the date of the financing is typical for a Series A financing), and (3) the number of times the investors may exercise Demand Registration rights (typically once or twice). Beyond that, and confirming the term sheet does not contain anything outlandish (ex. unlimited Demand Registration Rights exercisable at any time), you are better off focusing on improving other more important terms in the term sheet.

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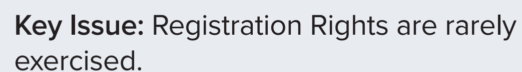

Key Issue: Registration Rights are rarely exercised.

Importance: Low

Tip: Don't sweat registration rights.

Right to Participate Pro Rata in Future Rounds (page 10)

The "Right to Participate Pro Rata in Future Rounds" – sometimes referred to as a "Pro Rata Right" – gives investors the right to purchase a portion of the stock or other securities offered for sale by the corporation in the future, subject to a few exceptions (typically the same as the exceptions to the Anti-dilution Provisions discussed earlier). It is typical for investors in financing transactions at all levels to request a Pro Rata Right, and from the company's perspective there is little harm in giving investors the option to invest more money, so inclusion of a Pro Rata Right in a term sheet is rarely a subject of discussion. With that said, it is in the company's interest to put some parameters around the Pro Rata Right to ensure the company has sufficient flexibility to raise money in the future from outside investors, if necessary.

The NVCA's model term sheet provides that the investors will have the right to purchase that portion of the offered securities necessary to allow each investor to maintain its percentage ownership of the company's outstanding common stock on a fully-diluted basis (i.e. if the investor owns 10% of the company's outstanding common stock on a fully-diluted basis before the offering, she would be entitled to purchase 10% of the securities offered). Investors are also granted the right to purchase a pro rata portion of any securities not subscribed for by other investors having Pro Rata Rights (this is called an Over-Allotment Right). Note that the model term sheet includes the option to limit Pro Rata Rights to "Major Investors," which are defined (in the preceding section of the model term sheet covering Management and Information Rights") as investors who purchase at least some minimum number of shares in the offering. This is a common means of limiting the scope of Pro Rata Rights because it benefits the company by reducing the number of investors having the right without taking any rights away from the lead investor (the threshold is always set below the amount the lead investor invests).

Investors will sometimes push for so-called Super Pro Rata Rights, entitling them to purchase more than their pro rata share of an offering on a fully-diluted basis. This can take the form of the right to purchase a multiple of the standard pro rata share (i.e., if a 2X right, an investor owning 10% of the company's fully-diluted capital before the offering would be entitled to purchase 20% of the securities offered). Alternatively, the formula for determining the pro rata share of the offering can be altered to increase the portion of the offering the investors as a group are entitled to purchase. Companies should push back hard on Super Pro Rata Rights as they are not market, but if this is a sticking point for the lead investor consider either (a) insisting that the Super Pro Rata Rights convert to standard Pro Rata Rights after a certain period of time or occurrence of a certain event (ex. the next financing) or (b) trying to add a Pay-to-Play provision (discussed below) or a simple "use it or lose it" provision so that investors who do not fully exercise their Super Pro Rata Rights lose them for future rounds.

Aside from attempting to put parameters around the investors' Pro Rata Rights, founders can also request that they also have Pro Rata Rights. This is usually an easy give for investors so long as it does not restrict the investors' Pro Rata Rights (which it would not unless the investors have Super Pro Rata Rights), though in practice founders often do not have the financial means to invest and when they do investors rarely object.

THE INVESTOR'S TAKE

"Super Pro Rata Rights fundamentally misalign incentives on how the company is operated, which is bad for both an entrepreneur and the VC."

– David Beisel, NextView Ventures

Key Issue: Super Pro Rata Rights

Importance: High

Tip: Pro Rata rights are market. Super Pro Rata Rights are not.

Pay-to-Play (page 6)

A Pay-to-Play provision provides that any investor failing to fully exercise its "Pro Rata Rights" to participate in a future financing (see "Right to Participate Pro Rata in Future Rounds" below) will have some or all of its shares of preferred stock converted into common stock or into another class of preferred stock with lesser rights (losing its anti-dilution protection and other rights in the process). This is clearly company-favorable because it penalizes investors who do not pony-up when the company needs more funding – particularly in a down round because it helps mitigate the negative impact of anti-dilution protections – but it also has positive consequences for those investors who do invest in future rounds because it prevents other investors from free-riding. While pay-to-play provisions are rare in early stage financing transactions, if the financing is syndicated the lead investors may be willing to accept a Pay-to-Play provision (and some even prefer to include one) in order to encourage smaller investors to participate in future rounds, particularly if the lead investor has the voting power to block any future financing where it does not want the Pay-to-Play to apply (see the discussion in "Voting Rights and Protective Provisions" below). Smaller investors, by contrast, are most likely to object to a Pay-to-Play.

Note that the Pay-to-Play can be applied to "up" or "down" rounds, though investors are usually much more willing to participate when the company's valuation is on the rise.

Key Issue: Pay-to-Play provisions are rare

Importance: Low

Tip: A Pay-to-Play can be an effective way to counter the effects of investor-favorable anti-dilution or Pro Rata Rights but are usually vigorously resisted by investors.

PART III: CONTROL TERMS

Once you have wrapped your head around the economics of the proposed financing, turn your attention to the Control Terms, which will impact how decisions are made going forward. Corporations have three levels of decision makers: the company's management makes decisions about day-to-day operations and makes recommendations to the company's Board regarding larger strategic matters; the Board appoints and oversees the company's management and must approve major transactions and other actions that may have a material impact on the company's business; and the stockholders elect the directors to the Board and must approve changes to the corporation's charter and transactions fundamental to the corporation's existence – most notably any sale of the company. Since the founders typically continue to control a majority of the company's voting stock following a Series A financing, the purpose of many of the Control Terms is to alter the default corporate governance structure to give the investors more power over decisions vis-à-vis the founders. While the investors have a legitimate interest in protecting their investment, founders need to carefully consider how the protective provisions will impact the company's operations and the founders' ability to influence decisions about the company.

Voting Rights and Protective Provisions (pages 4-5)

The Charter section of the NVCA's model term sheet contains the Voting Rights and Protective Provisions, which together define when investors will vote with the other stockholders and when they have the right to a separate vote.

Voting Rights The Voting Rights provision proscribes simply that the holders of preferred stock (i.e. the investors) vote together with the holders of common stock (i.e. the founders), on an as-converted basis, with three exceptions that are discussed elsewhere. The fact that the holders of preferred stock vote with the holders of common stock on an "as-converted basis" is important because it means that any anti-dilution adjustment to the preferred stock's conversion ratio, discussed earlier, will increase the investors' voting power vis-à-vis the holders of common stock in addition to giving the investors a greater share of the overall economic pie.

Protective Provisions The Protective Provisions give the holders of preferred stock a veto over certain corporate actions. Having separate voting rights in certain circumstances is important to investors because it prevents them from being outvoted by other stockholders with competing interests on matters that are critical to the investors. While this is reasonable when it comes to major corporate actions or actions specifically impacting the rights of the preferred stock, the Protective Provisions should not unduly inhibit the company's freedom of action by requiring investor approval for routine matters.

The circumstances in which investors have the right to a separate vote typically include at least (a) significant corporate events (ex. a sale of the company) and (b) actions that could adversely affect the rights of the investors (ex. amending the corporate charter or, if the investors have the right to appoint one or more directors, changing the composition of the Board of Directors). Sometimes more company-specific protective provisions will be included, such as the sale of a certain division of the company's business. The scope of the protective provisions should be commensurate with the stage and size of the investment, so investors in a Series A financing typically require more extensive protective provisions than investors in a Seed-stage financing. For example, Series A investors often insist on a block on the company's ability take on additional debt or change the size of the company's Board of Directors, whereas earlier investors often do not have a veto over those types of actions. If the Protective Provisions in the term sheet are too expansive, you can push to remove such items entirely or suggest instead that decisions about certain matters be made by the Board, including the director(s) appointed by the investors (see the discussion in Matters Requiring Preferred Director Approval below).

Key Issue: Scope of investor's veto rights

Importance: High

Tip: Investors as a group should only have a veto over major corporate actions and other actions critical to the investor, and the threshold for approval should be the lowest necessary to ensure approval of the lead investor(s) is required.

Matters Requiring Preferred Director Approval (page 10)

The Investor Director Approval provisions are, along with the Protective Provisions discussed above, the primary mechanism for the investors to exert control over the activities of the company. Approval of the investors' director(s) is often required for matters that could materially impact the company where seeking stockholder approval would either be inappropriate (because of the subject matter) or unduly burdensome. The NVCA's model term sheet includes a list of matters that may require approval of the investors' director(s), but the list is by no means exhaustive. The list of actions covered also tends to vary from term sheet to term sheet, so this section of a term sheet always merits special attention.

While companies are better off minimizing the decisions requiring approval of the investors (through the Protective Provisions) or their directors, being required to obtain approval of directors is preferable to being required to obtain stockholder approval for two reasons. First, the procedure for obtaining director approval is much simpler than for obtaining stockholder approval. Second, and arguably more important, it sets a higher legal bar for vetoing an action because directors, unlike stockholders, are subject to fiduciary obligations that preclude them from acting solely in their own self-interest (or the self-interest of the investors they represent). Therefore, in negotiating the Investor Director Approval provisions it is a good idea to be pragmatic: attempt to eliminate any actions that should be routine, but do not expend negotiating capital fighting over the need to obtain approval of the investors' director(s) for matters that are typically the purview of the Board, such as lending or borrowing money, approving related-party transactions, entering into material contracts or selling assets outside the ordinary course of the company's business.

THE INVESTOR'S TAKE

"The significance of matters requiring approval of the investors' directors depends on the risk of the deal and the risk of the founder. If it is a first-time founder this is a protection to ensure proper reporting and use of funds. We have seen cases where first-time founders do not have these provisions and it leads to a communication disconnect between the founders and investors. In one case, a founder spent $9M without investors or directors having a say in the matter."

– Senofer Mendoza, Mendoza Ventures

Key Issue: Limiting the scope of investors' director(s) veto rights

Importance: High

Tip: Many items subject to approval of the investors' director(s) can be narrowed by setting a dollar threshold below which approval is not required.

Board of Directors (page 14)

As we have already seen, a company's Board of Directors plays a pivotal role in the management of a company because it overseas the company's officers (and has the power to replace them) and because Board approval is required for many corporate actions, including most action that are expected to materially impact the corporation's business. Not surprisingly, then, the composition of a company's Board can be a contentious point of negotiation in a financing.

After a Series A financing, a company's Board will typically consist of five directors (an odd number helps prevent deadlocks), with two directors elected by the investors, two elected by the common stockholders (including the founders), and one director elected by all of the stockholders voting together.[9] At the time of the financing all the investors and all or nearly all holders of the company's common stock will sign an agreement (if using the NVCA forms, the Voting Agreement) setting forth who will have the right to designate each director, and requiring them to vote their shares in favor of the election of each designee. The Board of Directors section of the NVCA's model term sheet contemplates a typical five-person Board of Directors comprised of two directors designated by the investors (one specifically designated by the lead investor), one director designated by the holders of common stock (which in practice typically means the founders), the company's CEO and one "independent" director who is not an employee of the company and who is "mutually acceptable" to the other directors. While initially balanced – with the founders and investors each initially controlling two Board seats – over time the investors' influence over the Board can increase because they will have a say in the appointment of any new CEO and any new independent director, in addition to continuing to appoint two directors. The investors' influence over the CEO's Board seat is not immediately apparent because the CEO at the time of a Series A financing is typically one of the founders; however, if the founder is ultimately replaced as the CEO the investors will have considerable influence in selecting her replacement (hiring and firing of executive officers is typically one of the matters requiring approval of the investors' director(s)). The investors' influence over the independent Board seat is more direct because the investors retain a veto even though the director would otherwise be elected by a simple majority vote.

Founders should be cautious when negotiating the post-financing composition of the Board with investors. Some investors can add significant value to a company as members of the Board, but you do not want to give up too much control. Seed investors often do not receive the right to elect any directors, and should be offered at most a minority position on the Board. In a Series A financing, where investors nearly always insist on the right to appoint at least one and often two directors, your goal should be to ensure the Board composition and decision-making remain as evenly balanced as possible such as by: (a) requiring that the independent director and any new CEO be approved by unanimous consent of the other directors (which would necessarily include any director designated by the founders; (b) insisting that certain major corporate actions be approved by the director(s) designated by the founders, as well as the director(s) designated by the investors; and (c) if the CEO at the time of the financing is a founder, negotiating an employment contract for the founder-CEO that makes it difficult for the company to terminate her without "cause" (i.e. bad acts by the founder).

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Key Issue: Board Capture

Importance: High

Tip: To maintain a balanced Board, the common stockholders, or the director(s) they elect, should have the have the same rights as the investors or their director(s) to block changes to the Board composition.

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THE INVESTOR'S TAKE

"A board should typically be limited to five directors and should be generally representative of the major stakeholders on the cap table. Try to ensure the board is composed of people who bring real value and complement each other in the skills, relationships, and perspectives they add. Observers are fine, but too many can make for less efficient meetings."

– Matt Fates, Innospark Ventures

"

[9] At the time of a Seed-stage financing, the Board is often not more than three directors with one elected by the investors and either two elected by the common stockholders or one elected by the common and the other elected by all of the stockholders voting together, though it is not uncommon for the investors to forego a seat on the Board entirely until the Series A financing.

Management and Information Rights (page 10)

The Management and Information Rights section of the NVCA's model term sheet provides that the investors, or at least those that meet certain criteria, will be entitled to receive information from the company and have access to the company's facilities and personnel, regardless of whether the investor has the right to representation on the company's Board of Directors.

As alluded to in the model term sheet, receipt of a Management Rights letter is a legal necessity for any venture capital fund that manages assets subject to the Employee Retirement Security Act of 1974 (ERISA), which many VC funds do, because such funds must have certain "management rights" in their portfolio companies to avoid being subject to certain obligations under ERISA. "Management rights" include contractual rights running directly from the portfolio company to the fund that give the fund the right to participate substantially in, or substantially influence the conduct of, the management of the portfolio company. As a result of this statutory requirement, the delivery of a Management Rights letter to any VC fund that requires one is not controversial – and in fact is non-negotiable. The specific rights granted in the Management Rights letter are sometimes the subject of some discussion, but since these details are rarely included in the term sheet that discussion is typically left until the drafting of the definitive transaction documents. The NVCA's model Management Rights Letter provides that the recipient investor is entitled to: consult and advise the company's management on significant business issues; meet with management on a regular basis; examine the company's books and records, inspect its facilities and obtain other information about the company, subject to some limitations for highly confidential information; and receive copies of materials provided to the company's Board of Directors. For most companies, these rights are innocuous enough that the company may be willing to give Management Rights letters even to investors that do not require them.
In addition to management rights, the NVCA's model term sheet provides that all investors, or at least all "Major Investors," will: (a) be granted access to the company's facilities and personnel during normal business hours and with reasonable advance notification; and (b) receive other information from the company on a regular basis, including financial statements, an annual operating budget and capitalization table. If included in the term sheet, you may want to push back on the need to deliver monthly financial statements or audited annual financial statements until at least a year or two following a Series A financing because these require a certain degree of financial discipline and controls that it is unrealistic to expect of a fledgling company. The obligation to deliver regularly updated capitalization tables can also be a bone of contention, particularly where the company or some of its investors prefer the identity of some investors or the amount of their investments to remain confidential. To avoid this, companies often agree to deliver summary capitalization tables that aggregate each class of ownership so investors can determine changes in overall ownership and their percentage interest.

If the round includes a number of small investors, the company should insist on limiting the right to access facilities and personnel to Major Investors and may also want to push to limit management and information rights to Major Investors. This is not so much a practical issue – providing information to a few additional investors is usually of minimal consequence to the company – as it is the result of concerns that wider dissemination of sensitive information – such as financial statements, budgets and business plans – increases the likelihood that such information will leak out, putting the company at risk of losing its competitive advantage. Note that any investor who has the right to receive sensitive information from the company should be required to agree to keep the information they receive confidential, and a standard confidentiality provision should be included in the definitive transaction documents (if using the NVCA forms, in the Investor Rights Agreement).

THE INVESTOR'S TAKE

"I am of the mindset that most investors should be able to ask for information rights. It is not uncommon for us to require a side letter for information rights if we are not classified as a Major Investor. I've been in situations where we don't have access to a company's financials, and as a result, we don't know that the company is struggling, and because we don't know, we are unable to help. After all, we want the founder(s) to succeed as we all have skin in the game. So the more that you share with your investors, the more they are able to make informed decisions and provide assistance when you need it most. We are on your team!"

– Caroline Casson, Vitalize Venture Capital

Key Issue: Scope of Management Rights

Importance: Moderate

Tip: Management Rights should give investors access to information necessary to monitor their investment; but should not impose unrealistic obligations on the company.

Right of First Refusal / Right of Co-Sale (page 13)

Up to this point, we have covered Control Terms pertaining to who has the right to make decisions and the right to receive information. We now shift our focus to terms that pertain to the right to dispose of shares in the company, and restrictions on that right. We start with the two provisions in the aptly-named Right of First Refusal and Co-Sale Agreement, which gives the company and the investors certain rights vis-à-vis the company's common stockholders. The principal rights conferred are the eponymous Right of First Refusal ("ROFR" – rhymes with gopher) and Right of Co-Sale (a/k/a "Take-Me-Along" or "Tag Along"), both of which typically apply to any proposed sale of stock by common stockholders prior to the company's initial public offering. The inclusion of both rights is standard and rarely a point of contention, but there are certain details founders may want to negotiate in the term sheet.

Right of First Refusal

The Right of First Refusal provision in the NVCA's model term sheet gives the company, first, and the investors, second, the right to purchase shares proposed to be transferred by a common stockholder, subject to exceptions for transfers to affiliates (if the stockholder is an entity) or for estate planning purposes (if the stockholder is an individual. If a common stockholder subject to the agreement intends to transfer her shares to a third party, and none of the exceptions apply, she is obligated to notify the company which then has the option of purchasing some or all of the shares proposed to be sold on the same terms. If the company declines to purchase all of the available shares, some or all of the investors have the right to purchase the remainder. The ROFR order of priority may be reversed so that the investors' right precedes that of the company. The order matters because purchase by the company requires that the company come up with the purchase price but results in a proportionate increase in the value of shares held by all stockholders, whereas purchase by the investors does not drain the company's coffers but the investors purchasing shares increase their ownership interest vis-à-vis all other stockholders.

For founders, the most important aspect of the Right of First Refusal is whether the right is forfeit if the company and the investors do not collectively agree to purchase all shares proposed to be transferred. An "all-or-none" restriction on the ROFR is beneficial to selling stockholders because a prospective purchaser may not be interested in purchasing fewer than the agreed upon number of shares, particularly where it thwarts the prospective purchaser's ability to acquire a controlling stake in the company. The NVCA's model term sheet includes the investor-favorable formulation of the ROFR – allowing the company and the investors to purchase "any" shares proposed to be transferred – but the NVCA's model Right of First Refusal and Co-Sale Agreement includes an optional all-or-none provision. This is a good issue to clarify in the term sheet because it may impact the position of the parties on other elements of the ROFR and Tag Along provisions, such as who should be subject to them and exceptions for certain transfers (both discussed below).

THE INVESTOR'S TAKE

"The main investor protections we push for are most-favored nations rights, pro-rata rights, and information rights. For early-stage investments, you don't want to overburden the company."

– Daniel Acheampong, Visible Hands VC

Right of Co-Sale

If the Right of First Refusal is not exercised with respect to all the shares proposed to be sold, the Right of Co-Sale, or Tag Along, gives investors the right to sell their shares (after converting preferred stock to common stock, if necessary) to a prospective purchaser alongside the prospective seller. The Tag Along typically applies pro rata based on the relative ownership interest of the investors and the selling stockholder.

The Tag Along itself is not typically the subject of discussion at the term sheet stage, but you should confirm the term sheet does not contain any additional conditions that would further restrict the founder's ability to transfer shares.

* * * * *

There are three issues relevant to both the ROFR and Tag Along that it behooves you to try to clarify in the term sheet if you want them included in the final documents: (1) whether the investors will also be subject to the ROFR and Tag Along; (2) whether the rights should be granted only to a subset of the investors; and (3) whether there will be an exception to the ROFR and Tag Along allowing subject stockholders to sell a small portion of their shares. Making the investors subject to the ROFR and Tag Along is most common where there are a number of smaller investors because it is beneficial to both the company and the lead investor(s) that those investors not have an unfettered right to transfer their shares, with the associated rights, to third parties. Limiting the rights to a subset of investors is typically less controversial, provided the threshold is set low enough so as not to exclude the lead investor(s), because it eases the administrative burden on the company when the rights are triggered. Finally, and perhaps most importantly for founders, while both the ROFR and the Tag Along are usually subject to standard exceptions to permit stockholders to transfer shares for limited purposes, such as estate planning, you may want to negotiate for additional exceptions such as the right to sell a portion of your shares to generate liquidity (this is typically limited to 1%-5% of the shares of common stock held by the stockholder at the time of the financing).

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Key Issue: Founder Liquidity

Importance: Moderate

Tip: Founders can usually negotiate for the right to sell a small portion of their shares without being subject to the ROFR and Tag Along.

THE INVESTOR'S TAKE

"We deeply believe everyone should be in the same boat, so we restrict transfer of 100% of founders' shares. Founders should be making an adequate salary and see liquidity alongside investors. We have also found that selling early sends a bad signal to the market about the health of the company."

– Senofer Mendoza, Mendoza Ventures

Drag Along (page 14)

A Drag Along provision (also known as a “Bring-Along”) allows a subset of a company’s stockholders to compel most or all of the remaining stockholders to vote in favor of, and otherwise cooperate in consummating, a transaction that usually results in a change in control of the company. A Drag Along is typically triggered by a vote of one or more groups of the company’s stockholders and/or all or a subset of the company’s Board of Directors. Drag Along provisions are usually, though not always, included in a Series A term sheet (they are less common in earlier rounds). Whether the Drag Along is a point of contention depends on the voting trigger, which is driven by the underlying objective of the provision.

If the objective of the Drag Along is simply to ensure that all (or most) of the company’s stockholders will approve a transaction, the voting trigger will include approval of the transaction by the company’s Board and/or some portion of the holders of common stock, in addition to approval by holders of preferred stock. This sort of Drag Along is typically not a point of contention because it simply prevents dissent by a handful of minority stockholders from scuttling a deal. This can be particularly important in a transaction, such as a merger, where approval by all or almost all stockholders may be imperative or even required.

On the other hand, a Drag Along can also be used to compel most or all of a company’s stockholders to vote in favor of a transaction, even if it is only approved by a requisite portion (typically a majority) of the investors. This is a helpful right for the investors to have because the investors and the founders have different business and economic goals and incentives that may cause them to disagree about the merits of a potential acquisition.

This sort of Drag Along is most likely to be relevant if the investors are looking to exit and the company is presented with an acquisition offer that would return some money to the investors but little or nothing to the common stockholders.

The NVCA’s model term sheet does not take a firm position on the appropriate trigger for the Drag Along, instead presenting approval of the Board and the holders of common stock as options that can be included or excluded. In practice, it makes little sense for investors to insist on a draconian Drag Along at the time of a Series A financing because the founders usually retain a significant ownership stake in the company following the financing and there will likely be one or more additional financing rounds (during which the Drag Along can be modified) before the company is a viable acquisition target. Most investors opt for the middle-of-the-road approach suggested by the model term sheet, requiring approval of the company’s Board and holders of a majority of the shares of common stock then held by employees of the company, in addition to holders of a majority of the preferred stock, to trigger the Drag Along. Limiting the vote of common stockholders to those employed by the company is intended to prevent a founder who is no longer with the company from blocking a sale.

Key Issue: Who can trigger a Drag Along

Importance: High

Tip: Founders should insist that triggering the Drag Along requires approval of the Board and at least some segment of the common stockholders, in addition to the preferred stockholders.

THE INVESTOR’S TAKE

“Secondary sales are more common in later stage rounds; specifically, Series C onwards. Share restrictions align founders with key stakeholders, particularly with investors who don’t get liquidity opportunity until much later or an exit. In practice, decisions around founder liquidity are situational. In all cases, it is important that founders build rapport and trust with their investors in order to effectively make this ask during or shortly after a financing.”

– Payal Divakaran, .406 Ventures

Founders Stock (page 14)

At the time of a Series Seed or Series A financing (and sometimes in later rounds), investors typically require that the company's founders agree to subject some or all of their shares to "vesting," giving the company the right to repurchase any unvested shares if the founder is no longer working for the company. Vesting founders' shares helps to protect the investors (and other stockholders) by ensuring the founders have a financial incentive to stay with the company and continue to contribute to its growth and success. While the NVCA's model term sheet includes the term in brackets – suggesting it is optional – in practice it is always included unless the founders' shares are already subject to vesting on terms the investor's find acceptable.

The model term sheet provides for vesting over time but does not recommend any particular duration. Investors often initially propose the founders' shares vest over four years, with 25% of the shares vesting after one year (referred to as a "cliff") and the remainder vesting monthly or quarterly over the remaining three years. This is the standard vesting schedule for equity incentive grants in an early-stage company, such as options granted to employees, but is rarely appropriate for a founder that has spent months, or even years, building the company before the financing. At the very least, founders should receive some credit for time already served and vesting should start immediately (i.e. not be subject to a cliff). Investors will often also agree to full or partial acceleration of vesting of the founder's shares if (a) the company terminates the founder's employment without "cause" (generally defined as bad acts by the founder), (b) the founder leaves the company in certain circumstances (ex. the Board tries to relocate the founder or materially reduces her pay) or (c) the company is acquired or the founder's employment is terminated following an acquisition. If vesting or acceleration of vesting is not covered in the term sheet, it behooves you to raise the issue and insist it be clarified in the term sheet so it is not a sticking point later on.

While it is not typically addressed at the term sheet stage and there is no need to raise it, related to the issue of vesting is the question of whether under some circumstances the company should have the right to repurchase vested shares from founders who are no longer with the company. If the topic does come up, know that the only circumstance in which it is generally accepted that the company should have the right to repurchase vested shares is if the founder is fired for cause.

!

Key Issue: (Re-)Vesting Founders' shares

Importance: High

Tip: Vesting of Founders' shares is commonplace, but Founders should get credit for time served

THE INVESTOR'S TAKE

"For our investments where we are the very first check into a relatively newly formed company, we usually set founder vesting schedules from four years to something shorter. it depends on the situation, but founders understand what they're signing up for and usually as long as they're committed long term and they don't have some plans to leave in the near future, this conversation doesn't get any push back. For Series A investments, we still want to see founders vesting but often for less than four years."

– Tim Chae, 500 Startups

THE INVESTOR'S TAKE

"In most cases, we treat 25% of the founder's stock as fully vested, while the remaining 75% is vested over a period of three to four years. The extent to which this applies may vary depending on the company's progress and other circumstances."

– Daniel Acheampong, Visible Hands VC

PART IV: OPERATIONAL TERMS

The remaining terms in a typical term sheet – all of which are found in the Investors' Rights Agreement section of the NVCA's model term sheet – cover topics that apply to the company's operations more generally following the financing. These matters are typically not controversial and often left to the lawyers to hash out when negotiating the definitive transaction documents.

Non-Competition Agreements (page 11)

Historically, investors would typically insist that the company's founders and any other key employees be subject to a non-competition obligation lasting 12-24 months after the end of the founder's employment. This has become less common in recent years because as states have either prohibited employment non-competes (i.e. California) or imposed strict limitations and conditions on their use (i.e. Massachusetts). Founders should insist on equal treatment, even if some live in states that have more permissive non-compete laws, and a non-compete should not last for more than 12 months except in the case of an acquisition. If the investors push the founders to be subject employment non-competes, and none of the founders live in a state where they are prohibited, consider trying to negotiate a "garden leave" non-compete, which would require that the company continue to pay the founder part or all of her salary for the duration of the non-compete period.

Non-Disclosure, Non-Solicitation and Developments Agreement (page 11)

In any financing with sophisticated investors, the company will be required to ensure that all persons who may have had access to the company's confidential information or a role in the development of the company's intellectual property (a) agree that such information and intellectual property is confidential and belongs to the company, and (b) agree not to attempt to poach any of the company's employees, customers or other key business relationships for 12-24 months after the end of her employment. These are standard employment conditions for any employee of a startup and should not be controversial.

Board Matters (page 11)

Term sheets often include provisions addressing the operation of the company's Board of Directors, such as membership on Board committees, reimbursement of expenses incurred by directors, obtaining Directors & Officers insurance and director indemnification. These provisions usually apply (or should apply) to all directors. The exception is the composition of the Board's Audit Committee and Compensation Committee, which typically include at least one director appointed by the investors and one (or two, if there are two) "independent" directors, but not necessarily the CEO or the director(s) appointed by the founders.[10]

Employee Stock Options (page 11)

As noted earlier, employee stock options for technology companies typically vest over four years, with 25% of the options vesting after one year and the remaining options vesting monthly or quarterly over the following three years. This is industry standard and not a point to negotiate.

THE INVESTOR'S TAKE

"No deal at all can be better than a bad deal. Venture really isn't for everyone or every company. It creates expectations for growth that might be out of reach, and you have to remember that in the event of a sale, investors get their money back before the founders get anything. If your goal as a founder is a successful exit for you and your family, there are absolutely deal terms that would make that much more difficult than just not taking a deal. If that's your situation, and you're an early-stage company, I would look at ways to bootstrap, or pivot, or something - a bad deal for you is the market telling you that your company isn't viewed as a high performer, and you should listen to that feedback."

– Allison Lechnir, Hyde Park Venture Partners

[10] Founders usually do not meet the technical requirements to serve on the Audit Committee. The Compensation Committee is typically comprised of outside directors (those who are not also employees) and sometimes the CEO.

KEY TAKEAWAYS

Receiving a term sheet for an institutional financing is a tremendous opportunity. I hope this pamphlet has given you a better understanding of standard terms and how you can more effectively negotiate a term sheet so that, if you receive a term sheet, you can take advantage of the opportunity by getting the best deal for you and your company. In closing, here are a few key things to keep in mind when evaluating and negotiating a term sheet:

- ***Build a relationship:*** A term sheet marks the beginning of your relationship with a potential investor, and negotiating the term sheet is the first test of how well you and the prospective investor are able to work together to resolve conflicts. Treat the negotiation process as an opportunity to establish trust, transparency, and open communication. A difficult negotiation isn't necessarily a bad sign, but a contentious negotiation could foreshadow trouble in the future.
- ***Consider an investor's value-add:*** In deciding whether to accept a financing offer – and particularly if you are deciding between two investors – you must evaluate the non-financial attributes an investor brings to the relationship such as industry connections, expertise and mentorship. A supportive and well-connected investor can significantly benefit your company's growth and success.
- ***Keep Your Eye on the Prize:*** Fundraising is a means to an end. Don't hesitate to make concessions on terms if it gets you closer to your goal.
- ***Determine your priorities:*** Broadly speaking, the main areas of negotiation between founders and investors are those terms impacting the economics of the investment and control of the company. To negotiate effectively, you need to evaluate what is most important to you as a founder and understand how you can make tradeoffs between economics and control that will get you the best possible deal. Focus on terms – such as valuation, liquidation preferences, anti-dilution protection, board composition, voting rights and protective provisions – that will have the greatest impact.
- ***Don't overlook the power dynamics:*** Don't become so focused on economic terms that you cede too much control, as it will hamper your ability to make essential decisions for your company's future. A high valuation in a financing is meaningless if the company is not ultimately successful.
- ***There is Strength in Numbers:*** Your ability to negotiate better terms increases exponentially if you are able to get term sheets from more than one investor.
- ***Take your time:*** Don't rush into signing a term sheet. The terms of your first institutional financing will be the starting point for negotiating terms in subsequent rounds, so the impact of unfavorable terms, such as accruing dividends, is likely to be amplified. Carefully analyze each provision and ensure you grasp the long-term effects on your company's governance, financials and exit strategy. Remember that it's easier to negotiate terms before signing; changes become more challenging and expensive to make once the term sheet is finalized.
- ***Look out for red flags:*** In evaluating a term sheet or comparing term sheets, look out for indications the terms may be off-market, such as inclusion of participating preferred stock, full ratchet anti-dilution, redemption rights, super pro rata rights or other highly investor-favorable terms.
- ***Seek legal advice:*** An experienced startup lawyer can help identify potential red flags, clarify complex terms, and suggest appropriate modifications, which will safeguard you from costly mistakes and ensure your interests are protected in the long run.

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Ben is a partner with the firm's Corporate Group and a member of the firm's Venture Capital and Technology Team. Ben's practice is focused on representing companies in general corporate matters, debt and equity financing, mergers and acquisitions, securities law compliance, and joint ventures. He also represents private equity and venture capital funds, angel investors, and financial institutions in connection with the financing of public and private companies.

Ben serves as outside general counsel for many of his clients, advising company management on legal issues ranging from day-to-day matters to large strategic initiatives. He also coordinates and supervises the work of experts in other practice areas when appropriate. In addition to working with established companies, he has extensive experience working with entrepreneurs and startups, often getting involved when a business is still in its early stages and then he guides the founders through the formative early stages of their company's development.

As counsel to investors and financial institutions, Ben helps structure and negotiate debt and equity financing transactions, including venture capital, growth capital, asset-based loans and distressed debt workouts. He also frequently writes and lectures on the laws and regulations governing financing transactions and recent trends in deal terms.

Ben was previously co-chair of the Securities Law Committee of the Boston Bar Association from 2013 to 2015 and co-chair of the BBA's Venture Capital and Emerging Companies Committee from 2015 to 2017.

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Harvard Law School, JD (2003)

Carleton College, BA (2000)

Admissions

Massachusetts

Practice Areas

Corporate & Securities

Emerging Companies

Securities and Corporate Governance

Industries

Technology

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For informational purposes only. Past success does not indicate the likelihood of success in any future legal representation.

Appendix A
NVCA Model Term Sheet

This sample document is the work product of a national coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample document presents an array of (often mutually exclusive) options with respect to particular deal provisions.

Preliminary Note

This term sheet maps to the NVCA Model Documents, and for convenience the provisions are grouped according to the particular Model Document in which they may be found. Although this term sheet is somewhat longer than a "typical" VC Term Sheet, the aim is to provide a level of detail that makes the term sheet useful as both a road map for the document drafters and as a reference source for the business people to quickly find deal terms without the necessity of having to consult the legal documents (assuming of course there have been no changes to the material deal terms prior to execution of the final documents). For Series B and later transactions, consider substantially shortening to refer to deal terms being "consistent with prior rounds, subject to reasonable review by Lead Investor" (as noted in the prior sentence, deal terms often are negotiated further between term sheet and closing, so relying on a term sheet for one round in a later round may prove inaccurate).

TERM SHEET
FOR SERIES A PREFERRED STOCK FINANCING OF
[*INSERT COMPANY NAME*], INC.
[__________, 20__]

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [___________], Inc., a [Delaware] corporation (the "**Company**"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of the conditions to closing set forth below. This Term Sheet shall be governed in all respects by the laws of [___________].[1]

Offering Terms

Security:	Series A Preferred Stock (the "**Series A Preferred**").

[1] Because a "nonbinding" term sheet governed by the law of a jurisdiction such as Delaware, New York or the District of Columbia may in fact create an enforceable obligation to negotiate in good faith to come to agreement on the terms set forth in the term sheet, parties should give consideration to the choice of law selected to govern the term sheet. Compare *SIGA Techs., Inc. v. PharmAthene, Inc.*, *Case No. C.A. 2627 (Del. Supreme Court May 24, 2013)* (holding that where parties agreed to negotiate in good faith in accordance with a term sheet, that obligation was enforceable notwithstanding the fact that the term sheet itself was not signed and contained a footer on each page stating "Non Binding Terms"); *EQT Infrastructure Ltd. v. Smith*, *861 F. Supp. 2d 220 (S.D.N.Y. 2012); Stanford Hotels Corp. v. Potomac Creek Assocs., L.P., 18 A.3d 725 (D.C. App. 2011) with Rosenfield v. United States Trust Co.*, 5 N.E. 323, 326 (Mass. 1935) ("An agreement to reach an agreement is a contradiction in terms and imposes no obligation on the parties thereto."); *Martin v. Martin*, *326 S.W.3d 741 (Tex. App. 2010)*; *Va. Power Energy Mktg. v. EQT Energy, LLC*, *2012 WL 2905110 (E.D. Va. July 16, 2012)*.

Closing Date:	As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the conditions to closing (the "**Closing**"). [*provide for multiple closings if applicable*]
Conditions to Closing:	Standard conditions to Closing, including, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, [obtaining CFIUS clearance and/or a statement from CFIUS that no further review is necessary,][2] [and an opinion of counsel to the Company].[3]
Investors:	Investor No. 1: [_______] shares ([__]%), $[_________] Investor No. 2: [_______] shares ([__]%), $[_________] [as well other investors mutually agreed upon by Investors and the Company]
Amount Raised:[4]	$[________], [including $[________] from the conversion of SAFEs/principal [and interest] on bridge notes].[5]
Pre-Money Valuation:	The price per share of the Series A Preferred (the "**Original Purchase Price**") shall be the price determined on the basis of a fully-diluted pre-money valuation of $[_____] (which pre-money valuation shall include an [unallocated and uncommitted] employee option pool representing [__]% of the fully-diluted post-money capitalization) and a fully-diluted post-money valuation of $[______].

CHARTER

Dividends:	[*Alternative 1:* Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock.]

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2 To be included if the parties review the facts of the investment and determine that a CFIUS filing is warranted. Where a mandatory filing is necessary, that filing must be submitted 45 days in advance of closing, but obtaining CFIUS clearance in advance of closing is not a requirement of law. However, submitting a CFIUS filing and then closing before the review process is completed creates regulatory risks for all parties that are best avoided if the timing of the investment permits.

3 See NVCA Model Legal Opinion for detailed commentary on legal opinions.

4 This provision would have to be modified for staged investments or investments dependent on the achievement of milestones by the Company.

5 Convertible instruments that convert at a discount may provide for a "shadow" or "subseries" of Preferred that is identical to the new round security except with respect to the amount received on liquidation, so that in a downside exit scenario all investors are at best only getting their money back. Be clear in the term sheet whether the shares issued on conversion are part of the pre-money capitalization or post-money capitalization.

[*Alternative 2*: Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[_____] per share of Series A Preferred when and if declared by the Board of Directors.]

[*Alternative 3:* The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.][6]

Liquidation Preference: In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

[*Alternative 1 (non-participating Preferred Stock)*: First pay [__ times] the Original Purchase Price [plus [accrued and] declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock.]

[*Alternative 2 (full participating Preferred Stock)*: First pay [___ times] the Original Purchase Price [plus accrued and declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis.]

[*Alternative 3 (cap on Preferred Stock participation rights)*: First pay [___ times] the Original Purchase Price [plus accrued and declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).]

A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) or a sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "**Deemed Liquidation Event**"), thereby triggering payment of the liquidation preferences described

[6] In some cases, accrued and unpaid dividends are payable on conversion as well as upon a liquidation event. Most typically, however, dividends are not paid if the preferred is converted. Another alternative is to give the Company the option to pay accrued and unpaid dividends in cash or in common shares valued at fair market value. The latter are referred to as "PIK" (payment-in-kind) dividends, which are quite rare in this context.

above unless the holders of [___]%[7] of the Series A Preferred elect otherwise (the "**Requisite Holders**"). [The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to escrow or indemnity holdback in connection with a Deemed Liquidation Event.][8]

Voting Rights:

The Series A Preferred shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) so long as [*insert fixed number or %*] of the shares of Series A Preferred issued in the transaction are outstanding, the Series A Preferred as a separate class shall be entitled to elect [_______] [(_)] members of the Board of Directors ([each a] "Preferred Director"), (ii) as required by law, and (iii) as provided in "Protective Provisions" below. The Company's Charter will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock.[9]

Protective Provisions:

So long as [insert fixed number or %] shares of Series A Preferred issued in the transaction are outstanding, in addition to any other vote or approval required under the Company's Charter or Bylaws, the Company will not, without the written consent of the Requisite Holders, either directly or by amendment, merger, consolidation, recapitalization, reclassification, or otherwise:

(i) liquidate, dissolve or wind-up the affairs of the Company or effect any Deemed Liquidation Event; (ii) amend, alter, or repeal any provision of the Charter or Bylaws [in a manner adverse to the Series A Preferred Stock]; (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security unless the same ranks junior to the Series A Preferred with respect to its rights, preferences and privileges, or increase the authorized number of shares of Series A Preferred; (iv) sell, issue, sponsor, create or distribute any digital tokens, cryptocurrency or other blockchain-based assets without approval of the Board of Directors[, including the Investor

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7 Careful thought should be given to the voting threshold based on the makeup of the round, especially if multiple series/classes are implicated. Also bear in mind that anti-dilution adjustments may result in changes in voting power.

8 See Section 2.3.4 of the Model Certificate of Incorporation for an explanation of this provision.

9 For corporations incorporated in California, one cannot "opt out" of the statutory requirement of a separate class vote by Common Stockholders to authorize shares of Common Stock. The purpose of this provision is to "opt out" of DGCL 242(b)(2). If (contrary to the protective provisions in this Term Sheet) the Preferred Stock is *not* intended to be able to block future financings, include a 242(b)(2) waiver for the Preferred Stock as well.

Directors]; (v) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, other than stock repurchased at cost from former employees and consultants in connection with the cessation of their service, [or as otherwise approved by the Board of Directors[, including the approval of [at least one] Preferred Director]; or (vi) [adopt, amend, terminate or repeal any equity (or equity-linked) compensation plan or amend or waive any of the terms of any option or other grant pursuant to any such plan; (vii)][10] create or authorize the creation of any debt security[, if the aggregate indebtedness of the Corporation and its subsidiaries for borrowed money following such action would exceed $[____] [other than equipment leases, bank lines of credit or trade payables incurred in the ordinary course] [unless such debt security has received the prior approval of the Board of Directors, including the approval of [at least one] Preferred Director; [or](viii) create or hold capital stock in any subsidiary that is not wholly-owned, or dispose of any subsidiary stock or all or substantially all of any subsidiary assets; [or (ix) increase or decrease the authorized number of directors constituting the Board of Directors or change the number of votes entitled to be cast by any director or directors on any matter].

Optional Conversion: The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under "Anti-dilution Provisions."

Anti-dilution Provisions: In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

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

Where:

CP_2 = Series A Conversion Price in effect immediately after new issue

CP_1 = Series A Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock

[10] See footnote in model charter.

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)[11]

B = Aggregate consideration received by the Company with respect to the new issue divided by CP_1

C = Number of shares of stock issued in the subject transaction

The foregoing shall be subject to customary exceptions, including, without limitation, the following:

(i) securities issuable upon conversion of any of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [one] Preferred Director(s)], and other customary exceptions[12].

Mandatory Conversion: Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a firm commitment underwritten public offering [with a price of [___] times the Original Purchase Price][13] (subject to adjustments for stock dividends, splits, combinations and similar events) and [gross] proceeds to the Company of not less than $[_______] (a "**QPO**"), or (ii) upon the written consent of the Requisite Holders.

[Pay-to-Play: Unless the Requisite Holders elect otherwise, on any subsequent [down] round all holders of Series A Preferred Stock are required to purchase their pro rata share of the securities set aside by the Board of Directors for purchase by such holders. [A

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[11] The most broad based formula would include shares reserved in the option pool; a narrower base would exclude options or other convertibles. The formula above is the most typical.

[12] See Sections 4.4.1(a)(v)-(viii) of the Model Certificate of Incorporation for additional exclusions; consider building into the term sheet to avoid later "negotiation".

[13] The per share price floor generally benefits small/minority holders. Consider 1) allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the Investor, so that such Investor does not have the power to block an IPO and 2) whether IPO proceeds alone should be sufficient to establish the minimum requirements for an IPO that triggers conversion.

proportionate amount/all] of the shares of Series A Preferred of any holder failing to do so will automatically convert to Common Stock and lose corresponding preferred stock rights, such as the right to a Board seat if applicable.

[Redemption Rights:[14]	Unless prohibited by applicable law governing distributions to stockholders, the Series A Preferred shall be redeemable at the option of the Requisite Holders commencing any time after the five (5) year anniversary of the Closing at a price equal to the Original Purchase Price [plus all accrued/declared but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)].

STOCK PURCHASE AGREEMENT

Representations and Warranties:	Standard representations and warranties by the Company customary for its size and industry. [Representations and warranties regarding CFIUS.][15]
[Regulatory Covenants (CFIUS):	*To the extent a CFIUS filing is or may be required:* Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("**CFIUS**") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]].[16]

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[14] Redemption provisions are rare and even more rarely exercised. If included, note that due to statutory restrictions, the Company may not be legally permitted to redeem in the very circumstances where investors most want it (the so-called "sideways situation"). Accordingly, and particularly in light of the Delaware Chancery Court's ruling in *Thoughtworks (*see discussion in Model Certificate of Incorporation*),* investors may seek enforcement provisions to give their redemption rights more teeth - *e.g.*, the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company's Board of Directors, or shall have consent rights on Company cash expenditures, until such amounts are paid in full. Also, while it is possible that the right to receive dividends on redemption could give rise to a DGCL Section 305 "deemed dividend" problem, many tax practitioners take the view that if the liquidation preference provisions in the Charter are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the Model Certificate of Incorporation), then there is no Section 305 issue.

[15] To be considered in order to address issues under the Defense Production Act of 1950 and related regulations (DPA). Relevant representations may include whether or not a company works with "critical technologies" within the meaning of the DPA, whether a company has operations or activities in particular sectors of the U.S. economy or in the U.S. at all, whether a Company stores or maintains certain types of data, whether an Investor is foreign, and whether an Investor has foreign government relationships, among others.

[16] To be included if Investors review the facts of the investment and determine that a CFIUS filing is warranted. When the Investors are foreign persons, a CFIUS filing may be mandatory with respect to certain investments (*e.g.*, some transactions involving "critical technologies"), and voluntary but advisable with respect to others. This covenant may be paired with an explicit reference to the exercise of the redemption right in the Charter in the event of a CFIUS-

Counsel and Expenses:	[Company] counsel to draft applicable documents. Company to pay all legal and administrative costs of the financing [at Closing], including (subject to the Closing) reasonable fees (not to exceed $[_____]) and expenses of Investor counsel.

INVESTORS' RIGHTS AGREEMENT

Registration Rights:

Registrable Securities:	All shares of Common Stock issuable upon conversion of the Series A Preferred and any other Common Stock held by the Investors will be deemed "**Registrable Securities**."[17]
Demand Registration:	Upon earliest of (i) [three (3)-five (5)] years after the Closing; or (ii) [six (6)] months following an initial public offering ("**IPO**"), persons holding [__]%[18] of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than $[5-15] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered, and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).
Registration on Form S-3:	The holders of [[10-30]% of the][19] Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate offering price of at least $[3-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations,

mandated divestiture of shares. A CFIUS "notice" is a full-form filing that results in a definitive opinion by CFIUS regarding the national security risks associated with the transaction, but may take months to obtain; a CFIUS "declaration" is a short-form filing that may not result in a definitive opinion by CFIUS but is intended to be able to be obtained within 45 days. If a CFIUS filing is warranted, the parties may also elect to negotiate a basic statement laying out the scope of Investors' obligation to accept CFIUS conditions (*e.g.*, will Investors be obligated to accept conditions or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Investors?). Whether or not a CFIUS filing is made, the parties may wish to consider other risk allocation measures or terms; examples include unilateral or bilateral waivers of responsibility for CFIUS-related costs and penalties, indemnification terms, or other similar language.

[17] Although not typical, founders/management may sometimes be granted limited registration rights.

[18] The Company will want the percentage to be high enough so that a significant portion of the investor base is behind the demand. Companies will typically resist allowing a single investor to cause a registration. Experienced investors will want to ensure that less experienced investors do not have the right to cause a demand registration. In some cases, different series of Preferred Stock may request the right for that series to initiate a certain number of demand registrations. Companies will typically resist this due to the cost and diversion of management resources when multiple constituencies have this right.

[19] A percent threshold may not be necessary in light of the dollar threshold.

provided that there are no more than [two (2)] per twelve (12) month period.

Piggyback Registration: The holders of Registrable Securities will be entitled to "piggyback" registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [20-30]% on a pro rata basis and to complete reduction on an IPO at the underwriter's discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders' shares are reduced.

Expenses: The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions will be borne by the Company. The Company will also pay the reasonable fees and expenses, not to exceed $[______] per registration, of one special counsel to represent all the participating stockholders.

Lock-up: Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company held immediately before the effective date of the IPO for a period of up to 180 days following the IPO (provided all directors and officers of the Company [and [1 – 5]% stockholders] agree to the same lock-up). [Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to Investors, pro rata, based on the number of shares held.]

Termination: [Upon a Deemed Liquidation Event [in which similar rights are granted or the consideration payable to Investors consists of cash or securities of a class listed on a national exchange]] [and/or after the IPO, when the Investor and its Rule 144 affiliates holds less than 1% of the Company's stock and all shares of an Investor are eligible to be sold without restriction under Rule 144 and/or] [T][t]he [third-fifth] anniversary of the IPO.

No future registration rights may be granted without consent of the holders of [a majority] of the Registrable Securities unless subordinate to the Investor's rights.

Management and Information Rights:

A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requires one.[20]

Any [Major] Investor (who is not a competitor) will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such [Major] Investor (i) annual, quarterly, [and monthly] financial statements, and other information as determined by the Board of Directors; [and] (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year[; and (iii) promptly following the end of each quarter an up-to-date capitalization table]. [A "Major Investor" means any Investor who purchases at least $[______] of Series A Preferred.]

Right to Participate Pro Rata in Future Rounds:

All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet and shares issued in an IPO). In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

[Matters Requiring Preferred Director Approval:

So long as the holders of Series A Preferred are entitled to elect a Director, the Company will not, without Board approval, which approval must include the affirmative vote of [at least one/each of] the then-seated Preferred Directors:

(i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company; (ii) make any loan or advance to any person, including, any employee or director, except advances and similar expenditures in the ordinary course of business [or under the terms of an employee stock or option plan approved by the Board of Directors]; (iii) guarantee any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business; [(iv) make any investment inconsistent with any

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[20] See commentary in introduction to Model Managements Rights Letter, explaining statutory basis of such letter.

investment policy approved by the Board of Directors]; (v) incur any aggregate indebtedness in excess of $[_____] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business; (vi) hire, fire, or change the compensation of the executive officers, including approving any option grants; (vii) change the principal business of the Company, enter new lines of business, or exit the current line of business; (viii) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (ix) enter into any corporate strategic relationship involving the payment contribution or assignment by the Company or to the Company of assets greater than [$________].]

Non-Competition Agreements:[21]	Founders and key employee will enter into a [one] year non-competition agreement in a form reasonably acceptable to the Investors.
Non-Disclosure, Non-Solicitation and Developments Agreement:	Each current, future and former founder, employee and consultant will enter into a non-disclosure, non-solicitation and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.
Board Matters:	[Each Board Committee/the Nominating and Audit Committee shall include at least one Preferred Director.] Company to reimburse [nonemployee] directors for reasonable out-of-pocket expenses incurred in connection with attending Board meeting. The Company will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors. Company to enter into Indemnification Agreement with each] Preferred Director with provisions benefitting their affiliated funds in form acceptable to such director. In the event the Company merges with another entity and is not the surviving entity, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume the Company's obligations with respect to indemnification of Directors.
Employee Stock Options:	All [future] employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months].

[21] Non-compete restrictions (other than in connection with the sale of a business) are prohibited in California, and may not be enforceable in other jurisdictions as well. Some states (*e.g.*, MA) require additional consideration in exchange for signing and/or enforcing a non-compete. Consider also whether it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Non-competes typically have a one year duration, although state law may permit up to two years.

[Limitations on Pre-CFIUS-Approval Exercise of Rights: [22]	Notwithstanding anything to the contrary contained in the Transaction Agreements, Investors and the Company agree that as of and following the initial Closing and until the CFIUS clearance is received, Investors shall not obtain (i) "control" (as defined in Section 721 of the Defense Production Act, as amended, including all implementing regulations thereof (the "**DPA**")) of the Company, including the power to determine, direct or decide any important matters for the Company; (ii) access to any material nonpublic technical information (as defined in the DPA) in the possession of the Company; (iii) membership or observer rights on the Board of Directors of the Company or the right to nominate an individual to a position on the Board of Directors of the Company; or (iv) any involvement (other than through voting of shares) in substantive decision-making of the Company regarding (x) the use, development, acquisition, or release of any of the Company's "critical technologies" (as defined in the DPA); (y) the use, development, acquisition, safekeeping, or release of "sensitive personal data" (as defined in the DPA) of U.S. citizens maintained or collected by the Company, or (z) the management, operation, manufacture, or supply of "covered investment critical infrastructure" (as defined in the DPA). To the extent that any term in the Transaction Agreements would grant any of these rights, (i)-(iv) to Investors, that term shall have no effect until such time as the CFIUS clearance is received.]
[Springing CFIUS Covenant: [23]	[In the event that CFIUS requests or requires a filing/in the event of [ ]], Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("**CFIUS**") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]. Notwithstanding the previous sentence,

[22] To be included if Investors intend to close the transaction in stages, with at least one stage occurring before CFIUS clearance is obtained. The foreign investor side letter language on point would override any aspect of the other transaction agreements that might, until CFIUS clearance is obtained, grant control of the Company or access to aspects of the Company that might create grounds for CFIUS jurisdiction.

[23] To be included if Investors believe that there is risk that CFIUS may request a filing of the transaction at some future date or that a CFIUS filing may be required in the event of some future occurrence (*e.g.*, when the exit of another investor causes Investor to obtain control over the selection of a Board member). A springing CFIUS covenant provides certainty that all parties will proceed at CFIUS in orderly fashion. The further "notwithstanding" sentence ensures that while parties will cooperate to make the CFIUS filing, Investor will not be obligated to accept CFIUS-required conditions on the deal that might frustrate the purposes of its investment (*i.e.*, the Investor can abandon the proposed investment); more robust mitigation commitment language may be desirable from the perspective of U.S. companies or U.S. investors seeking to limit foreign investors' ability to abandon the transaction. For more information on the differences between electing to pursue a CFIUS notice vs. a CFIUS declaration and considering a reference to redemption rights, see footnote 16.

Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors' right to exercise control over the Company.]

[Limitations on Information Rights:[24]	Notwithstanding anything to the contrary contained in the Stock Purchase Agreement, the Charter, the Investors' Rights Agreement, the Right of First Refusal And Co-Sale Agreement, and the Voting Agreement (all of the agreements above together being the "**Transaction Agreements**"), Investors and the Company agree that as of and following [Closing/the initial Closing], Investors shall not obtain access to any material nonpublic technical information (as defined in Section 721 of the Defense Production Act, as amended, including all implementing regulations thereof (the "**DPA**")) in the possession of the Company.]
Other Covenants:	Consult the NVCA Model Investors' Rights Agreement for a number of other covenants the Investors may seek; Investors should include to the extent they feel any may be controversial if not raised at the Term Sheet stage.

RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT

Right of First Refusal/ Right of Co-Sale (Take-Me-Along):	Company first and Investors second will have a right of first refusal with respect to any shares of capital stock of the Company proposed to be transferred by current and future employees holding 1% or more of Company Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options), with a right of oversubscription for Investors of shares unsubscribed by the other Investors. Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.[25]

[24] To be included if Investors are considered foreign entities under the DPA and intend to make an investment outside the jurisdiction of CFIUS. This assumes that Investors intend not to obtain (i) a Board seat, observer, or nomination right, (ii) more than 10% of the voting rights in the Company, or (iii) control over decision-making at the Company, including with respect to Company technologies, data and infrastructure. If the Stock Purchase Agreements, Charter, and other Transaction Agreements contemplate an investment on those terms, then a disclaimer of information rights with respect to certain technical information should be the last necessary step to remove the transaction from CFIUS jurisdiction. Further markups of the other Transaction Agreements would be necessary to ensure that they are developed consistent with this intention.

[25] Certain exceptions are typically negotiated, *e.g.*, estate planning or *de minimis* transfers. Investors may also seek ROFR rights with respect to transfers by investors, in order to be able to have some control over the composition of the investor group.

VOTING AGREEMENT

Board of Directors: At the Closing, the Board of Directors shall consist of [______] members comprised of (i) [*name*] as [the representative designated by [____], as the lead Investor, (ii) [*name*] as the representative designated by the remaining Investors, (iii) [*name*] as the representative designated by the Common Stockholders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [___] person(s) who are not employed by the Company and who are mutually acceptable [to the other directors[26]].

[Drag Along: Holders of Preferred Stock and all current and future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options) shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by [the Board of Directors] the Requisite Holders [and holders of a majority of the shares of Common Stock then held by employees of the Company (collectively with the Requisite Holders, the "**Electing Holders**"), so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder's pro rata portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Charter, subject to customary limitations.][27]]

OTHER MATTERS

[Founders' Stock: Buyback right/vesting for [__]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [__] months.][28]

[Existing Preferred Stock:[29] The terms set forth above for the Series [_] Preferred Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform

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[26] Other formulations might be majority of Common then held by employees and majority of Preferred, for example.

[27] See Section 3.3 of the Model Voting Agreement for a list of additional conditions that might be required in order for the drag-along to be invoked.

[28] Most founders' shares are already subject to vesting; consider what level of vesting is appropriate and revise to marry up. Investors may also conclude not to change founder vesting.

[29] Necessary only if this is a later round of financing, and not the initial Series A round.

the existing Preferred Stock to this term sheet will be made at the Closing.]

No-Shop/Confidentiality: The Company and the Investors agree to work in good faith expeditiously towards the Closing. The Company and the founders agree that they will not, for a period of [______] days from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. The Company will not disclose the terms of this Term Sheet to any person other than employees, stockholders, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [_________], as lead Investor, without the written consent of the Investors (which shall not be unreasonably withheld, conditioned or delayed).

Expiration: This Term Sheet expires on [_______ __, 20__] if not accepted by the Company by that date.

[Signature Page Follows]

EXECUTED this [__] day of [_________], 20[__].

[Signature Blocks]