

Relationships Between Investors and Entrepreneurs/Managers: Term Sheets and Key Agreements

The Term Sheet

- Circulated at beginning of negotiations
- Summarizes the terms the proposer is willing to accept
- Nonbinding outline of the principal points that will be covered in detail in the Stock Purchase and other agreements
- Expedites the negotiation process

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The Term Sheet: Key Terms

- Investment and ownership
- Rights, preferences, privileges and restrictions of shares
- Redemption rights
- Information and registration rights
- Board representation and company meetings
- Employment agreements, new hires, and employee compensation
- Key person insurance
- Non-binding character of agreement

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Why deal structure matters.

- Suppose (naïve) venture capitalist structures deal with entrepreneur where VC invests \$1.5 m in exchange for 49.95% of the common equity.
- Deal with have an implied enterprise value of \$3m.
- There is nothing VC can do that prevents entrepreneur from immediately selling company for \$2m cash.
 - » Entrepreneur makes \$1m.
 - » VC loses \$500,000 (invests \$1.5 m, receives \$1 m from buyer).

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Securities Used in Private Equity Transactions

- **Common Equity**
 - » Basic unit of ownership. Subordinate to:
 - Government claims
 - Regulated employee claims (pension obligations)
 - Accounts receivable
 - Bank Debt
 - All preferred securities
- **Redeemable Preferred** (also called 'Straight Preferred')
 - » Value is its face value plus any dividends it promises.
 - » Often issued combined with common stock or warrants.
- **Convertible Preferred**
 - » Convertible at holder's option into common equity.
 - » Often mandatory conversion at liquidation events (sale or IPO).
 - » Sometimes contain antidilution provisions that adjust conversion price if new securities are issued at lower price.
- **Participating convertible preferred**
 - » Holder is entitled to face value plus equity if there is sale or liquidation
 - » Sometimes structure deals with 2 or 3 times participating preferred, so that holder get 2 or 3 times the face value if sale or liquidation.

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Term Sheet: Rights, Preferences, Privileges and Restrictions of Shares

- Dividends
- Liquidation preference
- Conversion rights
- Anti-dilution provisions
- Voting rights
- Default
- Protective provisions

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Term Sheet: Rights, Preferences, Privileges and Restrictions of Shares: Dividends

- Specifies amount per share
- Preference to common dividends
- Cumulative vs. non-cumulative
 - » This choice raises a number of questions
 - » If cumulative, what happens at conversion?
 - Lose rights?
 - More stock?
 - » If cumulative, what happens if merger, takeover, or other restructuring?

Term Sheet: Rights, Preferences, Privileges and Restrictions of Shares: Liquidation Preference

- Specifies what happens if the business is liquidated, there is a consolidation or merger in which company does not survive, or there is an asset sale
- Specifies investor preferences
- Typically receive preference equal to original investment plus cumulative dividends not paid
- Afterwards, share proceeds as though shares had been converted

Term Sheet: Rights, Preferences, Privileges and Restrictions of Shares: Conversion Rights

- Specifies rights of investor to convert shares to common
- At holders option or with limitations
- Events resulting in automatic conversion (e.g., IPO)

Term Sheet: Rights, Preferences, Privileges
and Restrictions of Shares: Anti-Dilution Provisions

- Specify adjustments to conversion price in the event of subsequent financings.
- Two alternatives
 - » Full ratchet
 - » Weighted average
- Play or Pay

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Term Sheet: Rights, Preferences, Privileges
and Restrictions of Shares: Anti-Dilution Provisions

- **Full Ratchet**
 - » Conversion price automatically ratchets down if a share of stock is issued at a lower price
 - » **Example:**
 - Assume 1,000,000 common and 1,000,000 preferred outstanding
 - Preferred conversion price of \$1 per share (e.g., investor can convert to 1,000,000 shares of common)
 - New financing: Firm sells 50,000 shares of common at \$0.50 per share
 - Conversion price “ratchets down” to \$0.50 per share. Investors can now convert to 2,000,000 shares.
 - Founder’s interest declines from 50% to 32.8%. Founder gets “burned out” of opportunity.

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Term Sheet: Rights, Preferences, Privileges
and Restrictions of Shares: Anti-Dilution Provisions

- **Weighted Average**
 - » The investors’ conversion price is reduced to a lower number that takes into account how many shares or rights are issued in the dilutive financing.
 - » **Example:**
 - Number of common shares outstanding before the transaction: 2,000,000 (A)
 - Number of shares that firm would have had to issue at old conversion price to raise the capital: 25,000 (C)
 - Number of shares firm actually issued: 50,000 (D)
 - Old conversion price: \$1 (OCP)
 - New conversion price:
$$NCP = ((A+C)/(A+D)) \times OCP = (2,025,000/2,050,000) \times \$1 = \$0.9878$$
 - Founder’s interest declines from 50% to 48.5%

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Term Sheet: Rights, Preferences, Privileges
and Restrictions of Shares: Anti-Dilution Provisions

- **Play or Pay**
 - » Addresses the “free rider” problem
 - » **Example:**
 - Preferred shares are convertible at \$1
 - Company gets in trouble and preferred shareholders agree to put up new money
 - If new price is \$0.50, common shareholder interests will be diluted
 - This is ok if all preferred shareholders participate in the new financing
 - Not ok if a preferred shareholder refuses to contribute and gets more stock because of anti-dilution provisions
 - » Requires each investor to contribute funds or suffer a penalty (e.g., conversion price is not adjusted or shares are automatically converted)

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Term Sheet: Rights, Preferences, Privileges
and Restrictions of Shares: Voting Rights

- Specifies voting rights
- Typically number of votes equals one per share that can be obtained on conversion
- Voting rights may differ for election of directors

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Term Sheet: Rights, Preferences, Privileges
and Restrictions of Shares: Default

- Specifies what will happen in event of a default (typically investors can elect a majority of the board)
- Events that constitute “default” are specified
 - » Voluntary departure of founder
 - » Involuntary departure of founder
 - » Death or disability of founder
- Specifies term of default provision. Typically expires with IPO or other reorganization in which firm does not survive

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Term Sheet: Rights, Preferences, Privileges and Restrictions of Shares: Protective Provisions

- Describes provisions that protect rights of the investors. For example, majority approval of investors may be required where
 - » Rights, preferences, or privileges of investors are materially affected
 - » Authorized number of preferred shares is increased
 - » New class of shares with similar or senior rights is created
 - » Sale or merger of company

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Term Sheet: Redemption Rights

- Specifies the rights of the investors to redeem their shares by requiring the company to repurchase them on specific dates at the original purchase price
- This gives the investors a series of put options
- For example, the investors may have the right to “put” specified fractions of their shares to the company on specified dates

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Term Sheet: Information and Registration Rights

- Spells out the rights of investors to receive information from the company and to demand registration of their shares
- See pages 9 to 13 of Term Sheet
 - » Information rights are necessary for investors to monitor what is happening at the firm
 - » Registration rights provisions may include
 - Demand registration rights (right to demand that company file a registration statement with the SEC)
 - S-3 registrations (simplified registration form)
 - Piggyback registration (right to piggyback on registrations of company)
 - Registration expenses
 - Right to transfer registration rights
 - Supermajority requirement for subsequent investors to have same rights
 - Other provisions

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Term Sheet: Board Representation and Company Meetings

- Non-management stockholders in a public company tend to be passive investors
- Managers of private equity funds tend to be active investors in that they often intend to influence the operations of the firm
- Typical founder is viewed as an incomplete manager
- Board that includes investor representatives is expected to fill the gaps
- Board is responsible for hiring/firing managers, setting managerial compensation, and ratifying and monitoring the major corporate decisions

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Term Sheet: Control Issues: Board Seats

- An important issue addressed in the term sheet is the presence of the investors on the board
- The Term Sheet may allow investors to elect a specific percentage of the board by virtue of their positions as preferred shareholders if they maintain a pre-specified ownership interest
- They may also have voting rights, in proportion to their ownership, with respect to the election of the other directors
- Investors may also require visitation or attendance rights and/or have the right to call a board meeting
- Ultimately, the control rights are allocated according to the **Golden Rule**

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Term Sheet: Employment Agreements, New Hires and Employee Compensation

- This portion of the Term Sheet specifies the key managers that the investors want to have employment agreements with
- Specifies the terms under which the company can hire new managers (e.g., with consent of investors)
- Describes the incentive compensation (options) that will be paid to managers
 - » Percent of shares
 - » Who will receive options
 - » Specifies benchmarks for option grants
- Specifies composition and responsibilities of compensation committee

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Term Sheet: Key Person Insurance

- Investors often require key person insurance
- Purchased by the company
- Protects against loss of value due to loss of key individual(s)
- Can be payable to the firm or to a trust for the benefit of the investors

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Term Sheet: Stock Restriction Agreement

- This provision can require founders, employees, and consultants to the company who hold shares to sign a stock restriction agreement
- Can give the company the right (option) to repurchase some of their shares at cost if they terminate their relationship with the firm before a specified date
- Can give the company the right of first refusal to purchase their shares at a specified price if they offer their shares for sale

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Term Sheet: Other Provisions

- Reserved employee shares (reserved for exercise of options)
- Right of first refusal for investors if company offers additional shares for sale (enables investors to retain their proportionate interest)
- Right of investors to sell shares if founder sells shares
- Right to sell company if founder fails to match an attractive offer
- Requirement for proprietary Information and Inventions Agreement
- Requirement for formal Stock Purchase Agreement
- Allocation of expenses

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Term Sheet: Non-Binding Character of Agreement

- This provision explicitly states that the Term Sheet creates no binding agreements
- Limits the potential problems if the investors decide to withdraw its offer to finance the company
