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Term sheet trends in the venture capital market

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Biotechnology investors wary of repeating recent history are negotiating tougher term sheets, but are investors' protections adequately balanced with managements' incentives?

After the stock market boom of the late 1990s and the subsequent bursting of the bubble in 2000, venture capitalists (VCs) and biotechnology company management are looking in their rearview mirrors for direction in negotiating the challenges on the road ahead. VCs, needing to safeguard their investments, are glancing over their shoulders and finding help in the tools of the past. The return of market fundamentals has heralded the return of the 'investor friendly/company tough' term sheet of the early 1990s. Although tough term sheets may well be here to stay, investors' purse strings have loosened since the bust. Venture capital investing remained largely stable in the third quarter of 2003 as US VCs invested about $4 billion in emerging companies, and has held steady at that pace during the past five quarters.

Understanding term sheets

A term sheet is a summary of the principal terms on which an investor is willing to make an investment in a company. Sometimes referred to as letters of intent, term sheets are often nonbinding, and give a company's board of directors a chance to evaluate the merits of a proposed transaction and 'see the whites of the investor's eyes.' For an investor, it provides the opportunity to clearly set out the terms and conditions needed to make a deal work. Although term sheets can be as simple or complex as the parties wish, the current trend is to produce a detailed term sheet so that both parties have a clear understanding of the transaction before spending valuable time and resources, only to discover down the road that they cannot agree on key points. But parties should resist the temptation to spend too much time negotiating the perfect term sheet or they will fail to move the transaction forward.

It is encouraging that despite the downturn in the level of VC investment from the late 1990s, 'good' companies—those with some combination of real earnings, valuable technology and experienced management—often have more than one interested investor. When faced with dueling term sheets, a company needs to analyze the terms and their impact on the company's current stakeholders, determine if the terms are in line with market trends, and assess whether the investor, who will be a long-term partner, has achieved a balance between his/her own interests and those of the company (which may conflict).

Three distinct themes are prevalent in each term sheet: the capital structure of the company, governance and the mechanics of the transaction. A working knowledge of the terms that affect each area is vital in evaluating any term sheet (see Box 1).

Capital structure

Capital structure is a term used to describe the parts of a company that form its capital. For most biotechnology startups, this largely comprises preferred shares purchased by VCs (as well as capital investments from angels and founders).

Valuation (or I think you forgot a zero).

Perhaps the most important element of a term sheet for both the investor and the company is the 'pre-money' valuation the investor assigns to the company. The pre-money valuation represents the dollar value that the investor determines the company is worth before its injection of new capital. This number lets existing investors and the company know how

much of a percentage of the company the investor expects to get back for its investment, and consequently, how much the ownership level of the current investors will be diluted.

For example, if the pre-money value of the company is $10 million and an investor intends to invest $10 million, the investor will end up with 50% of the company and the existing stockholders' investments will be halved. It is important, in today's economic climate, to realize that the valuation set in one round is not necessarily the floor for the starting point of the next round's valuation discussions. Obtaining a valuation of x today does not make a company immune from being valued at some amount less than x tomorrow. Increasingly, investors, realizing a company was overvalued during the heady days of the late 1990s, are imposing down-rounds (follow-on financings in which the valuation of the company is lower than the valuation at which the prior financing(s) were completed) or worse, wash-out or cram-down rounds (financings in which the valuation placed upon the company is so low that all equity issued previously is worth very little or, in some cases, nothing). Down-rounds are hard to swallow, but for a company overvalued during the boom, it may well be the only way to obtain desperately needed new capital.

Convertible preferred stock (preferable for whom?).

Most investors use convertible preferred stock as their investment vehicle. The preferred stock usually converts into common stock at a fixed conversion price. Conversion typically occurs either at the investor's option or automatically upon the occurrence of certain events (typically the company's initial public offering). The conversion feature provides the investor with a means to protect against dilution from subsequent issuances of equity securities. In the case of a subsequent financing at a lower valuation, the conversion price is adjusted. How that conversion price is adjusted is pivotal in determining the magnitude of the investor's price protection. The adjustment allows the holder of preferred stock to receive a greater number of shares of common stock and thus a greater percentage, or at least not a lesser percentage, ownership in the company upon the conversion of the preferred stock.

Throughout the boom, the conversion price was typically adjusted by applying a broad-based weighted average adjustment formula. By applying this formula, the impact of the dilutive (lower-priced) issuance is based on the relative percent that the equity sold in the dilutive financing bears to the total equity of the company, including the investors' shares, calculated on a fully diluted basis, giving effect to the exercise or conversion of all outstanding warrants, options, convertible securities or other equity derivative securities. The dilutive impact is spread among the investors' original investment price and the new dilutive issuance price by weighting the relative values and arriving at a blended conversion price. The new conversion price is lower than the investor's initial conversion price, but higher than the price of the dilutive issuance. In contrast, today, a full ratchet adjustment formula is the norm. With this formula, the investor's conversion price is ratcheted all the way down to the new, lower price per share of the dilutive issuance.

Dividends (only at the end).

Term sheets will usually provide that the preferred stock will generate a cumulative dividend (in other words, the dividend accrues whether or not declared). In most instances, the dividends will not be paid at regular intervals but instead will accumulate and be paid upon a liquidity event or at redemption. In addition, the preferred stock will get paid dividends before any dividend payments on the common stock.

Liquidation preferences (last in, first out).

Term sheets commonly specify that in a liquidation scenario (which typically includes sales, mergers or other changes of control and is not limited to dissolution or winding up), holders of preferred stock will be paid back their initial investment plus accumulated dividends first before holders of common stock are entitled to any distribution. A variation proposed by most post-1990s investors requires that holders of preferred stock be paid back some multiple of their initial investment, ranging from 2 times to as high as 12 times, plus dividends, again before any distribution is made to the holders of common stock. In addition, investors are now often requesting participating preferred stock, which entitles preferred holders to share pro rata with holders of common stock in any remaining assets after they have already been paid their liquidation preference.

Redemption (shut the lights on your way out).

Preferred stock may also have a redemption feature. Redemption allows the preferred stockholders, after a certain milestone (for instance, the redemption of another series of preferred stock) or the passage of a certain amount of time, to require the company to buy back the holders' preferred stock for the initial purchase price plus all cumulative dividends (whether or not such dividends are declared). This tool provides an investor with powerful leverage when it comes time to execute its exit strategy.

Governance

Term sheets address governance issues from two perspectives: among stockholders themselves and between stockholders and the company.

Stockholder rights (sibling rivalry).

Generally as among stockholders, investors will insist on including the following rights in the term sheet:

- Right of first refusal, which forces a specified group of stockholders who wish to sell their stock to solicit a third-party offer and then provide the beneficiary of this right with the opportunity to purchase all or some specified portion of the stock on the same terms and conditions as those specified in the third-party offer.
- Tag-along right, which gives a beneficiary the right to 'tag along' on a sale of stock and force a potential purchaser of a specified group of stockholders' stock to purchase that beneficiary's stock as well.
- Drag-along right, which gives a beneficiary the right to force the sale of the entire company (whether by way of stock or asset sale) to any third party they wish.

If a tag right or drag right is exercised, management or, in the case of a tag right or right-of-first refusal, other stockholders as well as management, could find themselves with a new owner or majority stockholder they had not contemplated when the original investment was made.

Protective provisions (Mother, may I?).

As between stockholders and the company, investors will also in general insist on:

- A laundry list of negative covenants, each of which will force the company to seek a specified percentage of stockholder approval and/or specific approval of one or more designated investors before taking certain actions such as issuing new shares of stock, entering into related party transactions or embarking on a new form of business.
- Some form of board and committee representation, or at a minimum (or occasionally, in addition to board representation), observer rights. Board observers do not have the right to vote on board actions, but are entitled to notice of the meeting, to receive board materials and to participate in the discussions at the meeting.
- A broad range of registration rights, including those that force the company to go public or register investor shares (demand rights) and conversely, those that allow the investor to participate and sell its shares in any registered offering initiated by the company or another stockholder (piggyback rights). Whereas in the boom period the minimum dollar value thresholds were high and lead time to execution thresholds were long, the last few years have seen a tightening of those dollar value and time thresholds.
- The right to participate in future financings.
- Pay-to-play provisions, which give an investor an added incentive to participate in future financings, since a failure to do so will result in the investor losing the benefit of future antidilution protection.

Mechanics

The final theme of most term sheets is the mechanics of the transaction. This is where the parties decide on the rules to get to closing and beyond.

To bind or not to bind?

Although most term sheets are nonbinding, there are three clauses that are typically binding on the parties:

- As mentioned earlier, recent experience suggests that when a company's prospects are bright it will have more than one suitor. As a result, 'no shop' or 'exclusivity' clauses, which restrict a company's ability to negotiate with more than one investor at a time, are becoming increasingly important to investors. The next chapter we see, borrowing a page from the merger and acquisition book, may be the negotiation of breakup fees in the event the company breaches the exclusivity provision—the theory being that actual damages would not adequately compensate the investor for the lost opportunity.
- Confidentiality provisions are also extremely important to both parties and are therefore another typically binding provision of a term sheet. These can be used to police the exclusivity clause and ensure that a company does not shop the terms of the transaction to other competing investors. They also give comfort to a company that the investor will not disclose the company's confidential information.
- Finally, both sides will ordinarily insist on terms governing the reimbursement of the investor's expenses, including the legal fees the investor incurs. Most investors today are asking the company to pick up those fees irrespective of whether the transaction ultimately closes.

Closing conditions (getting across the finish line).

The term sheet will likely set out the hurdles that must be cleared before the investor will fund the transaction. Conditions usually include the satisfactory completion of due diligence (a critical part of any investment) and the finalizing of definitive documentation. Conditions can also be more fundamental to the company's existing structure, and may involve implementing a new stock option pool or renegotiating employment

contracts.

An emerging trend today is for investments to be made in tranches, with obligations to fund future tranches contingent upon the company achieving a certain set of milestones or achieving milestones over a series of defined timelines. Milestones could be as specific as 'the signing of a new customer for x technology' or as general as 'the development of this year's budget.' The disadvantage for the company is that it does not get the full injection of capital up front, or perhaps ever, and may have to make adjustments to its business plan to efficiently operate on a reduced level of cash until those milestones are achieved.

Conclusions

In the wake of the technology market's collapse, the shift toward an 'investor friendly/company tough' term sheet has given investors more control (at macro and micro levels) over the direction of the company, their own exit strategy and the exit strategies of other investors. The Catch-22 with tilting the balance too much in the investor's favor is the demoralizing effect of leaving little incentive and empowerment for management and founders, the very people who will execute the strategy and hopefully generate a handsome return. VCs must make sure that while looking in their rearview mirrors for guidance from the past, they keep their eyes on the road ahead and structure term sheets that balance control and incentives in order to align the interests of investors and management.

This article is a general discussion of certain legal terms and should not be relied upon as legal advice. If you require legal advice, the author would be pleased to discuss with you the issues raised by this article in the context of your particular circumstances.

Box 1: Glossary

Convertible preferred stock. Preferred stock that is issued with the right of conversion into common stock.

Common stock. Shares issued by a company that typically can be traded either privately, pursuant to an applicable securities law exemption, or on an exchange if the company is publicly listed and the shares have been registered with the SEC. Holders of common stock are last in the queue if a company goes bust and has to sell off its assets.

Dividend. Distribution of part of a company's earnings to shareholders.

Initial public offering (IPO). The first offering of a company's shares to the public (known in the UK as a flotation).

Liquidation. An event typically covers sales, mergers or other changes of control as well as dissolution.

Preferred stock. Shares that give holders an entitlement to certain preferential treatment (*e.g.*, a multiple of their initial investment upon a liquidity event) when compared with holders of common stock. In the event of a winding up, preference shares rank above the claims of other shareholders in the company.

Redemption. The repurchase of a security (*e.g.*, preferred stock) by the issuing company.

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