Coming to terms

David H Oden, Jeffrey A Wolfson & Christina W Marshall

Before taking other people's money to finance your venture, it pays to fully educate yourself about the strings attached.

You've found an investor who's willing to make a substantial investment in your biotech company—that's great news. But after the handshake, the next thing is to negotiate the term sheet outlining the structure of the transaction to ensure a true meeting of the minds.

Term sheets should always be used in complex investment transactions—especially those involving venture capital investors or other institutional investors. The term sheet sets forth the key terms of the proposed transaction. A good rule of thumb is that the term sheet should address any provision that could kill the deal.

If you skip on drawing up a term sheet, then during the drafting and negotiation of the investment documents there may be no clear record of the parties' understandings on key issues. In the long run, this will cause confusion and discord, and any subsequent documents will probably take more time and cost more to draft and negotiate because the participating parties may be unwittingly using the definitive documents to negotiate—or renegotiate—key terms. Worse still, well into the process, it may become apparent that you are unable to reach agreement on one or more deal-killer terms and the transaction may collapse (**Box 1**).

In the following article, we guide you through the key steps in drawing up a term sheet. Getting this right is important to ensure you remain in control of your company and receive your share of returns.

David Oden is a partner and Christina Marshall is an associate at Haynes and Boone LLP, Richardson, Texas, USA. Jeff Wolfson is a partner at Haynes and Boone LLP, Washington, DC, USA.
e-mail: David.Oden@haynesboone.com, Jeff.Wolfson@haynesboone.com and Christina.Marshall@haynesboone.com

Box 1 Potential deal killers

During negotiations with an investor, you can encounter several hitches. These issues kill more deals than the U.S. Securities and Exchange Commission.

- Company technology undervalued by investor(s) or overvalued by founder(s).
- Valuation too dependent on issuance of meaningful patent protection.
- Partner(s) in joint development arrangements insist on absolute control of patent rights.
- Licensing exclusivity in which the partner or licensee in market is not incentivized to commercialize.
- Investor(s) or partner(s) insist on control of bet-the-company litigation.
- Founder(s) will lose too much control of the company.
- Deal requires clinical milestones that are realistically unreachable.
- Future company flexibility is too limited, particularly in partnering and/or development deals.
- Overly cumbersome approval process by investor(s) or partner(s) that could hinder rapid market response.
- Liability for clinical trials or indemnification in partnering or joint development deals.

Before the money

Although some lucky companies are approached by numerous venture capital funds, many have only one investor at a time. The availability and interest of venture capital often depends on the boom and bust cycles of the biotech industry and the economy as a whole (**Box 2**). At times, companies have been lucky to locate a single interested investor, whereas at other times they have had to fend off multiple investors or *limit* investment. If your transaction is with only one investor, it may be a bit simpler, faster and less expensive, though not by much. The downside of having only one investor is that there will be fewer pockets to reach into for the next financing. And, if the sole investor declines to participate in the next round, you will be in the position of starting from scratch to attract new ones.

If your transaction includes multiple investors, more money and expertise may be available to you. Additionally, there is a much greater likelihood that at least one investor familiar with the company and its technology will be able to participate in subsequent financings. In this case, the investors will generally select one to be the 'lead'—the party primarily in charge of due diligence, negotiations and preparation of the definitive investment agreements. During due diligence, the lead investor may examine multiple aspects of your company, including the technical expertise of the founders and key scientific employees, the market conditions and competition, the patent and trademark/branding positions of your company and clearance over any third-party intellectual property (IP) in the space, the R&D pipeline and future patent protection, the status and estimated cost of upcoming clinical trials, the status of US Food and Drug Administration (Rockville, Maryland) interaction and approval, the in-license and out-license agreements the company holds, the agreements with employees and consultants such as contract research organizations, and many other issues.

Box 2 Term sheet trends

During the past boom for biotech companies (about 9–10 years ago), companies could not have asked for more advantageous term sheets. At that time, investors were more fearful of missing out on a great opportunity than of losing their investment.

But the pendulum has inevitably swung back to reflect market conditions, so today term sheets tend to be very investor friendly. Biopharma venture capital funding has substantially decreased since the boom days, squeezed by conditions in the financial markets and, more recently, burned by the global economic downturn. With less biotech venture funding available, companies have had to give up more. Unless your company is an unusually attractive investment opportunity, do not expect much negotiating power at the term sheet stage.

That's a lot to handle, so to ensure a smooth diligence process with the lead investor, you should have your legal counsel (preferably independent from your regular IP counsel) pre-evaluate the portfolio and IP-related agreements to help identify and remedy any potential roadblock issues (like ownership of technology) before seeking investment.

The lead investor is usually the one investing the most money, and that group should be the main contact for you and your counsel. In this situation, a term sheet is absolutely essential, and all investors should participate in the drafting and negotiation of the term sheet. When all are comfortable with the terms, the other investors should step back and let the lead investor negotiate the rest of the documents based on the term sheet.

The next step is dealing with the type of security your investors will be purchasing in return for their financing: common stock, preferred stock, a promissory note (normally convertible into equity) or some combination of these (**Box 3**).

But perhaps the most important thing for you is the valuation the investors assign to your company. Before consummation of the deal, the investor and your firm will go through a very detailed evaluation to determine what portion of the company's total equity the investor will purchase. This valuation will involve looking at the company and its prospects, the values for comparable companies, the current investment climate and the general economic conditions. Valuation is a combination of art and science and therefore is open to substantial disagreement and negotiation. It can be particularly dependent on the results of a thorough due diligence investigation.

It's important because the total value will determine what percentage of the company the investor will purchase in exchange for the investment. To use a simple example, if the investor is investing $1 million in a company with a pre-money valuation of $1 million, then the investor will own 50% of the company after the investment (assuming that the company will have a value of $2 million post-money). If the company has a pre-money value of $4 million, then the investor will own 20% of the company post-money ($1 million being 20% of a $5 million post-money value).

This determination of value is a key area of conflict between founders and investors. Not surprisingly, founders usually want a higher valuation and investors typically seek a lower one.

Living with investors

Most founders are familiar with vesting—the concept that stock options will become exercisable (that is, they will 'vest') over time. Vesting is also typical in a venture capital investment, but in a different way: the founder will typically be asked to put his or her equity ownership at risk of being repurchased by the company in the event that the founder is no longer associated with the company for any reason.

The rationale behind vesting is that the venture investor is really betting on people (you and your team) as well as the company and the technology. If you leave, retire, decide to go in a different direction or get fired, then you'll no longer be in a position to push the company forward. And if you still own a substantial portion of the company, this is untenable for your investors.

For protection, an investor will typically ask you, the founder, to enter a vesting agreement, whereby all your stock is subject to repurchase by the company at a nominal price per share (typically, the price originally paid by the founder). The company's right to repurchase the stock will be triggered if the founder leaves the company for any reason, including the termination of employment. This right of repurchase generally decreases over time, so that at some point none of your stock is subject to repurchase. For example, in a five-year vesting (which is fairly typical), the company will have the right (but not the obligation) to repurchase 100% of the founder's stock for the first year after the investment, 80% in year two, 60% in year three and so on. After five years, none of the founder's stock will be subject to repurchase.

As a founder, your risk is the concern over being ousted by investors, perhaps to bring on a more business-savvy CEO. This often occurs even if you're performing well as chief executive. Many founders will seek provisions guaranteeing their position for a sufficiently long time, ensuring immediate vesting of rights or other protective measures like specifying a reasonable repurchase price for their stock if involuntarily or unexpectedly separated from the company.

Also up for discussion is the amount of control investors will have over the daily operations and major decisions of the company. Specifically, particular attention in negotiations should be paid to whether the investor gains a seat on the company's board, the power the investor has on the board and the voting rights the investor may have as a stockholder.

It is fairly normal for an investor to obtain one or more seats on the company's board of directors if the investment is a substantial amount of money and especially if the investor or a designee has expertise that will be helpful to the founders. The rationale here is that the investor wants the right to help control the company (and, in turn, try to protect his or her investment) and you want professional assistance in running the company.

Venture investors specialize in running and growing companies—most founders do not. A venture firm's presence on the board can really help those companies that need assistance with business aspects. When properly arranged, this can provide founders with a renewed opportunity to focus on what may be their core competency—the technology or science.

Still, the issue remains of how many board seats the investor is entitled to and the total size of the board. It would be common and expected that a large investor would be entitled to at least one board seat but uncommon to give the investor enough seats to control the board.

Investors normally require an agreement with the company and the other stockholders regarding the investors' rights as a stockholder. These voting agreements usually contain provisions permitting the investor to designate board members and prohibiting the company from taking certain actions without the investor's approval. Remember to heavily negotiate these aspects at the term sheet stage of the transaction as they will restrict your ability to run the company as you see fit.

Exit strategies

Because an investor's primary goal is to obtain a substantial return on his or her initial investment, the term sheet will include multiple provisions focused on how the investor will get the money back—the 'exit strategy'. These rights may include a liquidation preference,

redemption of the securities purchased by the investor and registration rights.

The type of security (**Box 3**) that the investor will purchase is directly related to its exit strategy. For example, investors may use a promissory note to try to protect their investment in the event that the company is sold or dissolved by having a 'liquidation preference' (liquidation includes being sold). Essentially, the liquidation preference says that if the company is sold or dissolved for whatever reason, the investor's investment (or a multiple thereof) is paid back in full before any funds are paid to other stockholders.

This should be of special concern to you because it represents an amount of money that will be paid out before you, as founder, get one dime of the proceeds. You should try to negotiate the most narrow liquidation preference possible to maximize the amount of money that will go to you and other stockholders. Tensions may arise only upon liquidation because the liquidation preference can often reveal diverging views between an investor, who might have little incentive to seek additional revenue for the founders at exit, and the founders, who would like to finally share in a payday after years of underappreciated efforts.

In the case of a strictly *failed* biotech company (not taken public or acquired, for example), the investors will typically take any available cash to recover their lost investment when assets are sold off to the highest bidder. The most valuable assets are often the patent rights and in-licensed rights, and they can be accompanied by trade secret information, such as clinical data from patient trials or even a Food and Drug Administration drug approval, as well as real estate, furniture and the like. Here you could often receive little or nothing due to the liquidation preference, but it may be possible to negotiate around the liquidation preference and obtain a share of any cash proceeds raised by asset liquidation.

Preferred stock that is 'redeemable' means that the stock must be repurchased by the company upon the happening of a specified event, such as the passage of time, an insufficient level of cash, a failed drug trial, poor clinical study results, criminal accusations over patient consent or merely at the option of the investor. The company will normally have to purchase the stock back at the investor's purchase price plus any accrued but unpaid dividends. Redemption is a feature of preferred stock that is generally demanded by investors in the current market.

Registration rights provide an investor with the power to register the shares of stock he or she owns during the company's initial public offering (IPO) or after the company has completed its IPO. Registered stock is freely transferable. Even so, it should be noted that although agreements regarding registration rights are enforceable, the underwriter may restrict or eliminate such rights at the time of an IPO depending on both the respective registration rights of other investors and the market conditions.

Box 3 Defining stock

All types of stock are not equal. The main types of stock that you will encounter fall into three categories:

Common stock. This is the normal type of stock that all companies issue, and the rights of common stockholders are set forth in the corporation laws of the company's state of formation. Common stock is usually owned by the founders.

Preferred stock. This is usually demanded by most professional investors. Preferred stock is created by amending the company's certificate of incorporation to include the type and amount of preferred stock issuable and the rights and privileges of the preferred stockholders. Preferred stock normally has preference over common stock when issuing dividends and distributing assets upon the liquidation or sale of the company. The terms of the preferred stock are typically heavily negotiated and should be discussed in detail in the term sheet to ensure the parties agree on this fundamental point.

Promissory note. This can take the place of stock and is usually convertible to common or preferred stock upon the occurrence of a certain event (for example, meeting one or more commercial milestones like successful phase 1, 2 or 3 trials), the passage of time or at the option of the investor. The terms of the promissory note are also heavily negotiated and should be addressed in the term sheet. The investor may prefer a promissory note because in the event of liquidation, noteholders typically recover their investment before any stockholders, even preferred stockholders. Convertible promissory note deals are common in very early stage investing or in so-called 'bridge' financings (short-term loans made in anticipation of subsequent equity financings).

Conclusions

Regardless of whether your transaction involves an investment, an asset purchase, a joint development project or a more complex structure, it is crucial for the parties to enter a term sheet—it will substantially increase the chances of successfully closing a deal. Also, having a written agreement that outlines the terms of the transaction will minimize the potential for confusion, costly negotiation and disagreement between the parties during the drafting and negotiation of the investment documents.

Depending on your need for capital and the relative attractiveness of your company to investors, the terms of a financing transaction may or may not be negotiable. If you do not immediately need funds and the investor finds your firm attractive, you will have more leverage negotiating financing terms than if you face an immediate cash crisis. Either way, you should pay particular attention to a few key terms of the investment. Specifically, try to negotiate advantageous positions regarding the percentage of equity the investor will purchase in the transaction, the amount of control the investor will have over the company's daily operations and major decisions and the amount of money the investor will receive upon the sale or liquidation of the company. These terms will directly affect the control you and the other founders have over the company post-investment, as well as your share of the investment returns.

Money can be hard to find right now, but according to a survey conducted by the US National Venture Capital Association (Washington, DC) in December 2008, (National Venture Capital Association, 2009 Venture Capital Predictions Survey Results, Dec. 17, 2008), the biotech and life science sectors are viewed as the second most promising areas for increasing venture investment. If that's correct, close scrutiny of term sheets in biotech ventures is going to become even more important than before.

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