What's In A Term Sheet? The World's Most Irritating Not-Quite-Contract

By Bruce Gibney of Founders Fund

Venture financings turn on three things: money, power and ignorance. These variables converge most violently in the term sheet, which proposes the basic relationship between the venture capitalist and the company. Term sheets have a set of short, formalized components which in combination quickly become exceedingly tangled and opaque.[1] It's not uncommon for the VC, lawyers, and the company to have significantly different interpretations of what the various terms in term sheets even mean. Worse, because term sheets require all parties to predict the likelihood of various outcomes for a company including its value and the timing and terms of future financings, complexity can't be avoided.

What's a term sheet, really?

The first thing to note is that *a term sheet is not a legal promise to invest*. In other words, a signed term sheet doesn't guarantee money coming in the door. A term sheet is only a contract to the extent that: (1) it requires you to keep the negotiations confidential and (2) it may prevent the company from looking at other suitors for a period (the "no-shop" or "exclusivity" provision).[2] Most term sheets have legalese (usually near the end) that translates as: while this in every way looks like a contract to invest, it has no legal force whatsoever. All a term sheet sets out is the broad parameters of an investment; it's the "Five Documents" (the stock purchase agreement, investor rights agreement, certificate of incorporation, ROFR & co-sale agreement and voting agreement) that set out the actual terms of the investment. These are negotiated later, based on the term sheet.

---

[1] Term sheets are like chess in this way; each term has a fairly limited range of operation but the combinations get migraine-inducing in a hurry.

[2] Throughout, I'm discussing term sheets for equity rounds that fall within a standard deviation of the average (or, more accurately, term sheets that are no worse than modestly bizarre). One of the problems with term sheets is that while they are supposed to be highly formulaic and limited, they can be as perverse as the parties want.

Money

The first thing a term sheet does is supply you with the means to calculate your economics, although doing so can be rather involved as you can manipulate various terms to arrive at wildly different ownership stakes and economic outcomes while keep the nominal "valuation" the same.[3] Taking the terms in their usual order on a term sheet (*i.e.,* in order of growing complexity):

Pre-Money Valuation

This is the value of the company "pre-money", i.e., before any new cash is invested. Unfortunately, even this simple term gets knotty, because the nominal and the effective pre-money may be different if you increase (or "refresh") the option pool. (See below for more on option pools.) It goes without saying that the nominal price per share is irrelevant in theory; it's the value of the company that matters, although you'll see people get uncomfortable with really large or small prices (pennies a share or hundreds of dollars a share).

How do you determine the pre-money valuation? For younger companies, the parties pick a number within a fairly arbitrary range set by the market consensus on what seems reasonable to pay for a team and an idea that hasn't been turned into a real product, much less a money-making business.[4] For more established enterprises, a number is selected within an (equally large, somewhat less arbitrary) range ginned up from models. The exact number within each of these ranges depends on the VC community's interest in the company.

Post-Money Valuation

The Pre-Money Valuation + Total New Investment = Post-Money. Frequently, you hear people talk about "$X on $Y". That means $X invested on a pre-money valuation of $Y. Post-Money Valuation = $X+$Y.

Type of Security

Typically, companies issue preferred stock[5], which comes (imaginatively enough) with a series of preferences (the lawyers often will refer to these as the "rights, preferences, and privileges" of the

---

[3] To take it to an entertaining extreme, through a combination of warrants and other mechanisms you could increase a nominal valuation from $10 million to $1 billion without affecting what an investor pays or how much of the company it owns. For hard-working engineers tired of hearing some non-numerate MBA nattering on about grabbing a $15 million term sheet for anencephalic vaporware, you can now throw back your own a trillion dollar valuation. You heard it here first.

[4] Because the exact valuation of a company is fairly arbitrary, people should be willing to move around a fair amount within the market range in order to work with people they have real affinity for.

[5] Some companies only have common stock and some companies are organized as LLCs, which have membership interests. These situations are sufficiently uncommon that your lawyer will either ask you to clean these up by converting into a C-corp or you already had good reasons for this capital structure and don't need advice on it.

stock), including the right to receive the proceeds of an exit before holders of common stock. (Just how much they get is covered in the sections on liquidation preference and participation.)

Dividends

There's usually a provision for dividends, "when and if" declared by the board of directors. Since dividends are rarely declared and are usually a nominal amount, this is not usually a point of contention. However, in a financing where you may lose control of your board, this provision takes on more importance.

Liquidation Preference

Liquidation preference ("liq pref" or "preference") provides additional downside protection to investors. It also reduces the total amount available to the holders of common (the entrepreneurs) when the preference is paid. Basically, it means that money used to buy preferred stock gets returned first, at a particular ratio if a "liquidation event" happens. The term sheet will specify what counts as a liquidation event later in the document, but in general it's an event equivalent to the company going away – getting acquired, merging, selling most of its assets. (It's not an IPO.) Preferences usually range from 1x to 3x (1x being typical), which means that an investor with a 1x preference gets his original investment back, with a 2x preference, twice the money, etc. –before the common holders get anything.

Liquidation preferences complicate things over multiple financings if they "stack," which basically means that some investors are "senior" to others and get paid their liquidation preference first. You could have many layers of liquidation preferences at difference ratios and caps (see "participation" below – as noted, this gets complicated quickly). Alternatively, all preferred shareholders could have a pari passu preference, which just means the proceeds get divvied up to all preferred holders at the same time.

Does it matter? For many start-ups, it doesn't in a downside scenario because there are usually so few assets left that no one gets anything. (It's not like GM going under, where you have billions in property, plant and equipment even though the company can't pay its bills.) And for very successful companies, it may not matter because this provision doesn't get invoked unless investors have negotiated for fully participating preferred, as the preferred holders would convert to common stock (see below), forego their liquidation preference and share pro rata with the common holders.

Self-serving this is, but in general a 1x liquidation preference is perfectly reasonable. If you're a very risky enterprise likely to have many hard assets at the time of failure, higher preferences aren't unreasonable.

Participation

Participating preferred is another investor-friendly provision, this time driven by genteel optimism (participating with a cap) or something less restrained (fully participating). Participation is a share in the leftovers. The common stockholders and preferred stockholders will share in whatever the remaining proceeds of sale are on a pro rata basis (*i.e.,* the percentage of the company they would have owned had their preferred stock converted into common).

Aggressive investors ask for fully participating which means that the holders of preferred receive their preference *and* share in the distribution of any remaining proceeds, alongside the holders of common.

The intermediate case is participating preferred stock with "capped" participation, meaning that the holders share in the distribution of remaining proceeds until they've received a set amount (typically 2x to 4x the initial investment).

More frequently, the preferred is "non-participating" meaning the holders do not share in the distribution of remaining proceeds following the receipt of their preference.

Holders of capped participating preferred and nonparticipating preferred have a choice to make in connection with a liquidation event: they can forego their preference and convert to common prior to the transaction if participating as a common holder would result in a higher return to them. For example, if an investor has a 3x cap but the pro rata share of proceeds from a sale would be 10x, the investor would convert, giving up his preference but getting an additional 7x. Sometimes this conversion gets determined automatically for the holders of preferred and sometimes the holders get notice prior to the event and must elect whether to convert.

Option Pool

The option pool can confound everyone involved, especially when comparing two term sheets with different nominal valuations and option pool treatments.

The pool represents the pot of stock (or rather, the reserve of stock into which the options will convert if exercised) held aside for existing and future employees and other service providers, to make them happy workers. Typical option pools range from 10-20%, with the percentage determined on a pre- or post-money basis.[6]

Refreshing on a pre-money basis dilutes existing holders and not the new investors. Companies can think of it as reducing the effective value of the stock held by the existing holders, because all shares in the newly-increased option pool will be included in the pre-money valuation and the existing holders will therefore hold proportionately fewer of the shares, while the valuation remains constant. The standard is to include the refreshed option pool in the pre-money valuation, on the assumption that people like high (nominal) valuations and also understand the mechanics of the pool well enough to know what's happening.

Refreshing post-money (or failing to refresh a pool at all, and doing it in between financings) dilutes everybody, which means both old and new shareholders share in the dilution.

Adjusting the pre-money valuation up or down would eliminate the need for all of shenanigans with the option pool, but no one ever does so - headline valuation is king.

[6] Generally, the parties set the pool at an amount sufficient to satisfy equity grants for a year or two.

Conversion

Conversion transforms preferred stock into common stock, usually at 1:1 basis. The *conversion price* is just the price that achieves that desired ratio – divide the amount invested by the conversion price, and you get your ratio. Conceptually simple, conversion gets involved when you consider participation caps, drag-alongs, and IPO rights, all discussed below.

Anti-Dilution

In its simplest form, anti-dilution rights are neutral and confer no advantage to either side. What these rights provide is that if a non-economic transaction is taking place - something that changes the number of shares without changing economics - the appropriate adjustments will be made. If the company splits its stock 2:1, the number of shares the investor holds will also double, *e.g.*

Of course, things get more complex as investors try to optimize downside scenarios, which can pit the investors against the company and even investors against investors. These situations occur if the company has a down round (technically, when it issues shares for less than the conversion price). The investor's goal is to protect his relative ownership in the company, at the expense of the company and future investors. This is called "price-based antidilution."[7]

Full-ratchet anti-dilution. Frankly, pretty bad for the company. If new stock is issued at a price lower than that paid by the prior investor with full-ratchet protection, the prior investor's conversion price is reset to the price paid for the new stock (*e.g.,* if the prior investor paid $1.00 per share for 100,000 shares of preferred stock and then the company issues a single share of additional stock for $0.10, each of the prior investor's 100,000 shares of preferred stock would thereafter be convertible into ten shares of common stock). This happens regardless of how much new money comes in. Needless to say, this is bad for the company, not least because it scares off new investors. This isn't a particularly common provision these days, but it does happen.

Weighted average anti-dilution. Much more fair for the company. Basically, this method tries to figure out the extent to which the old investors are diluted by an issuance of new stock at a price below the price paid by the old investors, as compared to an issuance of the same number of shares of new stock at the price paid by the old investors, and makes a proportional adjustment. The issue here is that new investors may well want to dilute the old investors, because they are assuming extra risk (the down round implying that things aren't going great).[8]

Pay to Play

But wait, there's more. Frequently, significant investors want to ensure that other investors continue to support a company when things are not going well, but when there's nevertheless still some chance that things eventually pan out. This works to a company's advantage and it's called "pay to play".

---

[7] The anti-dilution mechanism kicks in during the future down round, but is negotiated beforehand in the term sheet, for obvious reasons.
[8] Then there's broad-based vs. narrow vs. narrowish anti-dilution, but investors almost always get the first it's not worth the cerebration.

In a pay to play, each investor has to invest a certain amount in later financings or suffer one or more penalties, including: (1) forced conversion to common, which strips them of any preferred rights they used to hold; (2) stripping the investor of anti-dilution protection; (3) depriving them of various control rights. Pay to play is cold comfort for an entrepreneur, because it gets invoked only when things are tough, but it's still comfort. At the same time, investors who aren't leading the round (and therefore aren't negotiating the termsheet) can get squeamish about having this imposed on them, so be careful here if you have concerns about filling out your round.

Warrants

Sometimes, investors who are bullish on a company but don't want to put in more money right away will ask for warrants, which is the right to buy more stock at a particular price within a particular timeframe.

Warrants are slightly troublesome for the company, because they add complexity to a cap table. Warrants get exercised when the value of the company exceeds the strike price of the warrant (*i.e.,* the amount the investor pays). That's dilutive for subsequent shareholders. However, they can be an appropriate reward for investors who managed a quick and easy process or took a lot of risk with an initial investment. For these reasons, warrants are quite common in debt financings and as sweeteners, where you want to achieve a certain price or result, but need an additional inducement for the VC.

Costs of Counsel

Investors ask for a certain amount of legal fees to be reimbursed. The typical range is $25-75,000. Don't spend much time on this.

Summary – Economic Terms

At some level, the best term sheets just reach a reasonable agreement on valuation, because it's so hard to predict which of the various other terms will ever come into play and because they are tedious to negotiate. But entrepreneurs like high nominal valuations and VCs like complexity wherever they can get it, so be prepared to see all of these terms in some form or another. Now, how else can we complicate things? Power.

Control and Investors' Rights

In most cases, the board of directors has ultimate control over a company and the shareholders have ultimate control over the board of directors, subject to limits imposed by the financing documents and state law. Investors negotiate for all sorts of rights, but I'll cover the core set. The first three rights are narrow, almost economic, terms that investors always ask for and that companies always give.

Participation Rights

Absent participation rights (sometimes called a right of first refusal, or a "ROFR"), a company has no obligation to sell stock in future financing rounds to existing investors. Investors, being bullish on the company, want to ensure they are able to participate and ask for a right of first refusal usually equal to their pro rata portion of the proposed financing (i.e., if they own 10% of the company, they can buy 10% of the next round). There's no way to get out of this one and not a lot of good reasons to do so, although you may find yourself in a situation where you want to add a strategic investor. In that case, the value the strategic investor brings may offset the investor's expected dilution and in many cases it would be reasonable to ask the investor to invest less than its full pro rata.

Co-Sale and ROFR

If you get out, we get out: that's the essence of the co-sale right. Whatever percentage a founder or other key holder sells of his stake, the investor gets to do the same, to the same buyer. This term is as unavoidable as it is reasonable.

The ROFR (right of first refusal) gets invoked when a founder or other key holder wants to sell stock to a third party. In most cases the company will have a right to buy the stock, on the same terms on which the holder proposes to sell to the third party.[9] This right is normally in the company's bylaws or in the agreement governing the initial purchase by the holder. A primary purpose for this right is to enable the company to control its stockholder base. In connection with a financing, the investors will want the company to assign this purchase right to the investors, either before the company has a chance to exercise the right, or only if the company passes on the opportunity.

Registration Rights

It's hardly worth negotiating these rights, which require the company to register investor stock for sale on the public markets. In theory investors holding these rights could force a company to go public, though that's almost unheard of, for obvious reasons. And many times the portion of these terms get renegotiated when the underwriters take the company public (and they have almost all the power there) and it's in neither the investor's nor company's interest to spend much time on these.

Board Representation

A typical board has between 3-7 directors, split among (a) the founders and other company executives, (b) the investors (or their designees) and (c) often, independent members affiliated with neither party.

It's in everyone's interest to have a small board, because they are more efficient. While the amount of speaking grows super-linearly with the number of people on the board, other complexity grows exponentially. Start-up boards of more than 7 are almost inevitably useless (or worse). Unfortunately, many VCs take vanity seats, cluttering up the board.[10] One fix is to have the VC hold the seat by right

[9] There are occasionally small exceptions for estate management and family planning.
[10] Some VCs actually have to take a seat if they own X% of a company. VCs that proceed so mechanistically are seldom fun to work with, either as a company or as another investor.

but appoint an industry expert in their place (sometimes the VC is the industry expert, in which case: problem solved).

Board observers present another problem. Smaller shareholders often ask for these faux directorships on the basis that they are costless to the company – in theory, observers don't speak during board meetings but in practice, they speak quite a bit. Companies should not underestimate how tedious a large number of observers can be.

Investor directors are generally elected by class of preferred stock, with the largest investor or investors in a given preferred round having the ability to nominate a person to sit in the seat and the other preferred holders agreeing to vote in favor of the nominee (meaning the common stockholders don't participate in the nomination or the election). Over several financing rounds, that produces a lot of directors, some of whom have invested very little money. Capping a board at a small number of directors helps flush out the system, which is good for everyone.

Boards can fire CEOs or force a company to take drastic actions the founders may not approve of – VCs and companies are not perfectly aligned – so the balance of power among investors and company representatives can be critical. A very few companies have gotten around this by granting founders super-voting shares, which allow the founders to control almost everything. It's very rare that investors will agree to this and at least for public companies (newspapers do this a lot, *e.g.*), it's not at all clear this leads to the best returns for the company.

Voting Rights

Investors will normally require an approval right over any actions that would be adverse to the investors. It's fair to grant investors the right to block any action that would affect them disproportionately or unfairly – *e.g.,* something that singled out all preferred shareholders or even Series B preferred shareholders named Karl.

Frequently, investors request the consent of the holders of X% of a given class or series of stock before the company can engage in any number of transactions, like a sale, a subsequent financing, etc. That X% can be a bare majority, but frequently investors will seek a *personal* blocking right by negotiating for an approval threshold that relates to a very particular number: 100% minus the exact number of shares a particular investors holds, plus one. Companies should be very reluctant to agree to these potential hostage-taking situations, unless the investor has taken an extraordinary risk on the company/there has been a bad history. Unlike approvals at the board level, where board members' ability to take self-interested positions are tempered by their fiduciary duties, there are very few limits to a stockholder's ability to vote its shares in its own self-interest. At best, these veto rights (which is what they are) slow down corporate decision making. At worst, the investor can badly impact future financings.

Information Rights

Many investors who don't have a board seat ask for information rights. As a general matter, there's no reason why this request shouldn't be granted, although sometimes these rights require the company to “consult” with the VC, which is less appealing. These rights are normally limited to protect highly confidential or competitively sensitive information.

Major Holders

One way to make many of the foregoing rights more bearable for the company is to confine rights to “major” shareholders. What constitutes a major shareholder is context dependent, but it’s always clear who is major and who isn’t. Usually the set of major shareholders is defined by reference to a shareholding threshold.

Drag Along

These provisions allow the majority of shareholders to “drag along” smaller shareholders to a sale of the company – in other words, this provision removes the possibility of small shareholders turning into rogue nations and halting a sale until they can extort a higher payment. In general, these are good things. However, a company may wish to avoid drag along if it has a substantial minority shareholder whose liquidity visions are more aligned with the company than the other investors. There are various flavors of drag along provisions, with the primary sources of variation coming from (a) whose approval is needed to invoke the drag (just the holders of a majority of the preferred? Also the holders of a majority of the common? Also the board?) and (b) who gets dragged (just the common holders? The preferred holders as well?). While theoretically interesting, this is also a good strategy to waste $10k in legal expenses.

Summary – Rights & Power

It’s no surprise that money is power. If the round isn’t competitive, the investor’s money wins. If the round is competitive, because VCs believe the company is a one way ticket to the moon, the expected return from the investment translates into leverage for the company.

Regardless, it’s important to craft term sheets that are fair. Each side can spin dials in its direction, but that leads to mistrust and discontentment in a relationship that may last years. Given the huge uncertainty in outcomes, it hardly seems worth optimizing six different sets of outcomes when the time could be better spent building the business. There’s a great psychological temptation to do so, I realize: (1) because founders are always nervous that they might be screwed and (2) because VCs have so little other control over the outcome.

For founders, hopefully a more transparent term sheet limits any lingering sense that the VCs can hoodwink them. For VCs, hopefully more transparency on the arcane bits of the term sheet will allow everyone to concentrate on a reasonable valuation and standard protections, and get on with letting the entrepreneurs make everyone money.

Then again, people are inventive. New terms are bound to emerge.